The Manufacturers Hanover
Economic Report

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The Tip of the Iceberg

Seeing the apparent inability of the Administration to reduce the Federal Government's budget deficit, a number of observers have begun to belittle its impact on the economy. Comments to this effect have originated from such disparate sources as the financial press, academia — and even from the Administration, itself. In my view, Washington's inability to balance its books is even more important than it appears. This is because the reported deficit is but the tip of the Federal financing iceberg. And like the real thing, what you don't see can hurt you every bit as much as what you do see, if you hit it.

Right now, the economy is reeling because the credit markets have slammed into this iceberg. Although they have retreated in recent weeks, interest rates are still high — especially when you take the rate of inflation into account. The level to which real interest rates rose this past summer was enough to cause a rapid runup in business failures and unemployment along with a steep decline in economic activity.

In their search for a villain, a number of observers both in and out of government have sought to blame Wall Street for talking itself into high interest rates and low stock prices. They point out that the deficit alone should be little cause for concern since it amounts to a relatively small percentage of the gross national product compared with earlier years. The point is also made that our budget deficits look relatively small by international standards. Finally, there are those who aggressively assert that there is no evidence linking budget deficits to either money growth, inflation or interest rates.

Supply And Demand

Those who attack Wall Street would certainly realize, if they thought for a minute, that investors, traders and even speculators don't deliberately want to see themselves go to the poorhouse. As much as they would like to see the financial markets rally, the demand for funds is so much greater than their supply that it prevents such a salutory development from occurring. In particular, the demand for money from Washington is even greater than the reported budget deficit indicates. This means that even if Washington were to make some progress in reducing its deficit, the financial markets would not necessarily jump for joy. For the Government regularly raises funds that are not reflected in either the budget deficit or in the national debt (the accumulated total of each year's budget deficit or surpluses). What the markets are saying is that the deficit is a symbol of a much larger Federal government presence in the marketplace, and if Washington cannot control the visible portion, how can it be expected to reduce the portion that lies beneath the surface, away from public scrutiny?

Table 1
FEDERAL AND FEDERAL-RELATED BORROWINGS
($ billions)

Fiscal Year	Direct Treasury*	+ Federally-Sponsored Enterprises	+ Guaranteed Loans	= Total Federal and Federal-Related Borrowings
1960	2.2	0.4	3.0	5.6
1961	1.4	−0.3	5.0	6.1
1962	9.8	1.1	4.1	15.0
1963	6.1	0.4	5.5	12.0
1964	3.1	1.9	4.2	9.2
1965	4.1	1.2	5.2	10.5
1966	3.1	1.8	4.1	9.0
1967	2.8	−3.9	2.1	1.0
1968	23.1	2.6	5.6	31.3
1969	−1.0	3.1	9.0	11.1
1970	5.0	11.0	1.9	17.9
1971	19.4	−2.1	16.1	33.4
1972	19.4	0.7	19.8	39.9
1973	19.3	10.6	17.7	47.6
1974	3.0	10.9	10.5	24.4
1975	50.9	5.3	8.7	64.9
1976	82.9	4.1	11.2	98.2
1977	53.5	12.0	14.0	79.5
1978	59.1	21.4	13.9	94.4
1979	33.6	21.9	26.1	81.6
1980	70.5	21.4	32.4	124.3
1981 (e)	75.4	27.8	51.3	154.5

* Borrowings to finance both on- and off-budget (primarily Federal Financing Bank) outlays.
Source: Treasury Dept.

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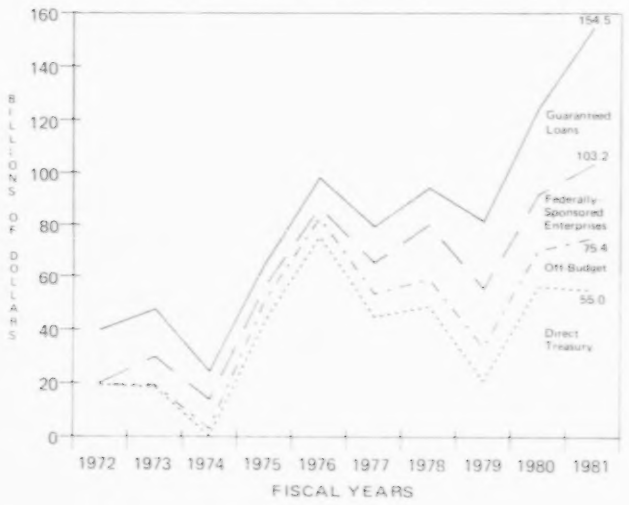
In order to see the true nature of Washington's presence in our capital markets, it is necessary to change the fraction that people so commonly look at (the ratio of deficits, or debt, to the GNP). What I will describe below will, in effect, enlarge the numerator while shrinking the denominator.

A Distorted View

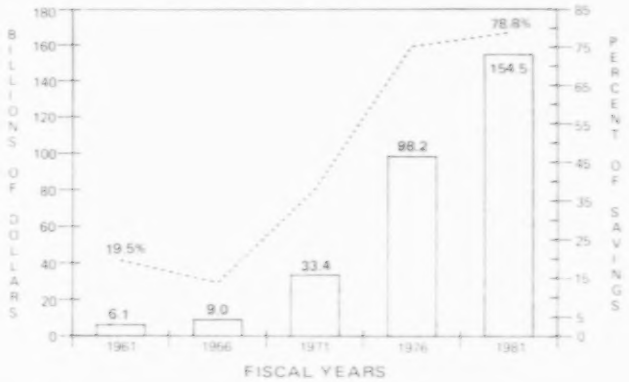
Since 1973 the reported budget deficit has provided an increasingly distorted picture of trends in Federal finance. This is because of the numerous "off-budget" programs that have proliferated in recent years. For example, in addition to financing fiscal year 1981's budget deficit of about $58 billion, the Treasury also raised some $17 billion "off the books," so to speak, through the activities of the Federal Financing Bank. Created at the end of 1973 and commencing operations in 1974, the FFB (which possesses unlimited borrowing authority at the Treasury) is authorized to purchase the debt and loan assets of such on-budget agencies as the Export-Import Bank and the Farmers Home Administration. Additionally, such entities as the Postal Service, U.S. Railway Association, and the Rural Electrification and Telephone Revolving Fund have regularly tapped the financial markets via the FFB for credit under Washington's umbrella — yet are not included in the official budget totals.

CHART I
COMPONENTS OF FEDERAL BORROWING



Then there are the Federally-sponsored enterprises. Such organizations as the Federal National Mortgage Association, Banks for Cooperatives, Federal Intermediate Credit Banks, Federal Home Loan Banks and Home Loan Mortgage Corporation and the Student Loan Marketing Association are able to borrow in the credit markets with the backing of Washington. The Congressional Budget Office estimates that these Federally-sponsored enterprises raised nearly $28 billion in fiscal year 1981 in addition to the $75½ billion that was raised to finance the on- and off-budget outlays described above. Table I shows how these enterprises have increased dramatically their fund-raising over the past two decades. Also shown on Table I is a third column depicting guaranteed loans. Six years ago, in 1975, less than $9 billion worth of guaranteed loans existed. In fiscal year 1981, that number amounted to over $51 billion! To be sure, the Federal Government does not actually borrow this money itself, but its guarantee enables another borrower to move to the head of the line, in effect, pushing others in the credit market to the rear.

CHART II
TOTAL FEDERAL BORROWING (BAR) VS.
TOTAL FEDERAL BORROWING
AS A PERCENT OF SAVINGS (DOT)



What all this means can be discerned from a look at the last column in Table I — Total Federal and Federal-related borrowings. As you can see, it is the sum total of direct Treasury, Federally-sponsored enterprises and guaranteed loans. The Treasury Dept. estimates that this total exceeded $154 billion in 1981. By contrast, it was $98 billion in 1976, $33½ billion in 1971, $9 billion in 1966 and a little more than $6 billion 20 years ago. Chart I shows how this total has grown since the early 1970s — especially those portions of Federal government involvement in the credit markets that don't show up in the budget.

It's Savings That Count

But this is only a part of the story. The denominator of the fraction must be restated as well — only in this case, made smaller. Many people tend to look at the size of either deficits or the total debt outstanding relative to the size of the economy and claim that the government's red ink is not a problem. It is true that the current deficit is running about two per cent of the GNP compared with 2⅓ per cent in fiscal 1980 and almost 3½ per cent in the 1975-76 period. It is also true that our budget deficits are small in comparison with other countries. Finally, it is also a fact that following World War II, the national debt

outstanding amounted to three times the size of the gross national product whereas today, even at the enormous sum of $1 trillion, it is only about one-third of the GNP.

All of these statements, however, fail to take into account the fact that it is not a country's gross national product that is called upon to finance these deficits. Rather, it is its stock of savings that must do the job. According to the Federal Reserve Board, the economy generated about $196 billion in savings in 1981, reflecting business-related earnings, personal savings, and state and local pension fund contributions. This was up a healthy 15 per cent over 1980—but it occurred at a time when Federal and Federal-related borrowings rose 24 per cent. This one-year trend typifies the experience that the economy has undergone over the past two decades as you can see from Table II and Chart II. The financing required by Federal and Federal-related borrowings in fiscal year 1981 took nearly 79 per cent of available savings. This compares with 75 per cent in 1976, 38 per cent in 1971, and 16¾ per cent in 1966 and in 1961 combined.

Table II

FEDERAL AND FEDERAL-RELATED BORROWINGS VS. TOTAL SAVINGS

Year	(1) Net National Savings* (Billions of Dollars)	(2) Federal and Federal-Related Borrowings** (Billions of Dollars)	Federal and Federal-Related Borrowings As A Percent Of Total Savings
1960	29.0	5.6	19.3
1961	31.3	6.1	19.5
1962	38.6	15.0	38.9
1963	38.3	12.0	31.3
1964	47.6	9.2	19.3
1965	58.2	10.5	18.0
1966	65.4	9.0	13.8
1967	70.4	1.0	1.4
1968	69.4	31.3	45.1
1969	64.8	11.1	17.1
1970	70.1	17.9	25.5
1971	87.8	33.4	38.0
1972	102.1	39.9	39.1
1973	118.1	47.6	40.3
1974	100.4	24.4	24.3
1975	110.6	64.9	58.7
1976	130.8	98.2	75.1
1977	168.3	79.5	47.2
1978	177.0	94.4	53.3
1979	174.8	81.6	46.7
1980	169.9	124.3	73.2
1981	196.0	154.5	78.8

(1) Calendar Year

(2) Fiscal Year

* *Total savings* equals gross private savings (corporate and household), plus state and local government surpluses and capital grants received by U.S. less net foreign investment and capital consumption allowances

** *Federal and Federal-related borrowings* are the sum of direct Treasury borrowings, Federally-guaranteed loans and borrowing by Federally-sponsored enterprises.

Sources: Federal Reserve; Treasury Dept., MHT Co.

Let me knock down a couple of other arguments as well. There *is* a relationship between Federal borrowing and the money supply. Over the past dozen years, the Federal Reserve has expanded the money supply as the Federal government's borrowing has preempted more and more of national savings. And, as you might expect, since excess growth in the money supply has been identified as a basic cause of inflation, there is also a discernible relationship between Federal borrowings and the rate of inflation.

Of course, the Federal Reserve is no longer following a policy of replacing the funds that the Federal government borrows in an effort to hold interest rates down and make funds available for private-sector borrowers. The Central Bank has switched from trying to manage interest rates, to attempting to control the growth of the money supply. While this may seem necessary to curb inflation, it does limit the amount of funds available to the private sector as long as Washington borrows heavily.

Is There Any Hope?

Going through this exercise makes it very difficult to come up with any kind of an optimistic conclusion over where this economy is headed. If this Administration cannot eliminate the visible budget deficit, who else will be able to do it? Additionally, since more and more Federal government credit demands take place in ways that are not measurable in the budget but certainly are felt in the financial markets, how will these activities be brought under control? That they have to be brought under control there is no doubt. For if they are not, more and more of national savings will be preempted by Washington. This will cause interest rates to remain high, the economy to remain depressed and our potential to compete in world markets to become seriously diminished.

Are we going to accept this, or are we ready to start scaling back the scope of government to not only do more for ourselves, but do it in a more efficient way, in a climate of less inflation and lower interest rates? Only time will tell. H

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The Manufacturers Hanover
Economic Report

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DECEMBER 1981

How's That Again?

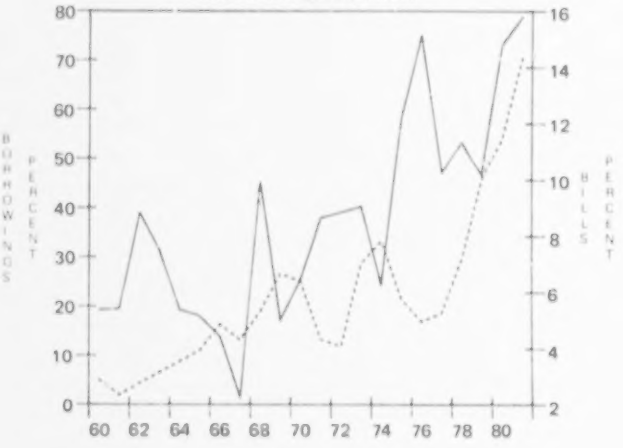
In last month's Economic Report, I discussed the true size of Washington's annual financing requirements by presenting data showing that there exists additional Federal credit needs which amount to several times the size of the reported budget deficit. And by comparing these Federal borrowing needs with the supply of savings that the economy generates, I showed how less and less was left for the private sector. I said that, to make up for this, the Federal Reserve in the past expanded the money supply—but that this eventually produced increased inflation. And I concluded that since the Fed is no longer following a policy of replacing the funds Washington borrows in order to hold down interest rates, the result was first high interest rates, as borrowers were crowded out of the financial markets, then slow (now no) growth, as more and more firms found that the cost of borrowing was too much for them to absorb or pass along.

Since some economists—both in and out of the Administration—insist that budget deficits don't damage the economy and that there is no direct relationship between red ink and inflation, high interest rates and the nation's money supply growth, I thought I would continue where I left off last month by showing you the relationships that have actually prevailed over the past two decades. I plan to use charts, rather than tables or complicated equations, so that the linkages will be unmistakeably clear even to the lay person. And, as you know, just using numbers alone can be misleading, since certain periods can be omitted to prove a point. Once you study these charts, you will be able to judge for yourself what lies ahead, if Washington continues to run large and growing deficits (on- and off-budget) while the Federal Reserve pursues its recently-adopted policy of concentrating on the money and credit aggregates and paying little attention to interest rates.

The Fed Accommodated the Treasury . . .

First, some points of agreement. The reported budget deficit has, indeed, had little relationship with interest rates—especially in recent years. This is because, as I said—and demonstrated—in the November Economic Report: "Since 1973, the reported budget deficit has provided an increasingly distorted picture of trends in Federal finance." There has been such a proliferation of off-budget financing since the early 1970s that by fiscal year 1981 the budget deficit represented less than 40 per cent of Washington's total credit needs. Plainly, the entire Federal financing "iceberg" must be looked at nowadays to get the true picture of Washington's impact on the credit markets.

CHART I
TOTAL FEDERAL BORROWINGS AS A % OF TOTAL SAVINGS (LINE) VS. AVERAGE MARKET YIELD ON 3-MONTH T-BILLS (DOT)



Second, I would not have expected to see a direct link between even total Federal financing and interest rates over the past ten or 20 years. This is because, until recently, the Federal Reserve used to conduct monetary policy in such a way as to minimize—if not reverse—the immediate upward pressure on interest rates that can accompany Treasury financing by purchasing the securities the government sells. In other words—when the Fed ran a monetary policy that mainly sought to achieve certain interest rate objectives, it found itself at times "monetizing" Washington's financing needs—that is, replacing the funds that Washington drew out of the credit markets in order to keep money available and interest rates low. Chart I clearly shows that, if anything, there was an *inverse* relationship between total

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Federal borrowing needs and three-month Treasury bill rates from 1960 until the end of 1979. (But see how both lines trend upward—this reflects the bidding up of "real" interest rates over time from the increased competition for funds.)

. . . Until Two Years Ago . . .

Notice however, what has happened since the end of 1979. Short-term interest rates (as measured by the three-month Treasury bill) seem to have established a direct relationship with Federal borrowing. The reason for this sudden shift is not hard to find. Late 1979 was when the Federal Reserve changed its policy from managing interest rates to managing the money and credit aggregates. Since the Fed was no longer attempting to match the demand for funds, but rather, was concentrating on its supply, the cost of money (interest rates) quickly reflected the pressures the government was putting on the credit markets—pressures that may well intensify in the current fiscal year, if the Administration's recent estimates of its budget deficit alone are any guide.

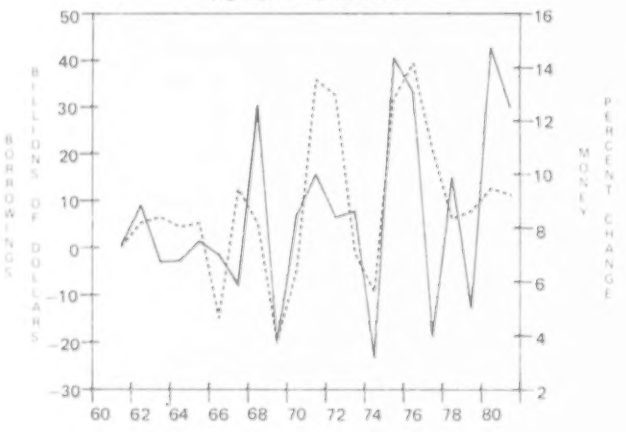
CHART II
TOTAL FEDERAL AND FEDERAL-RELATED BORROWINGS (LINE) VS. MONEY SUPPLY M2 AT YEAREND (DOT)

Now let's look at the consequences of the Fed's earlier policy of ignoring the monetary aggregates and concentrating on interest rates. Logic would tell you that the Federal Reserve cannot control the price of money (interest rates) and its supply simultaneously unless the demand for funds is fixed. Under a monetary policy that called for achieving certain interest rate objectives, the Fed implemented open-market operations whose procedures resulted in monetization of the government's debt. If Washington's financings tended to push interest rates above the range the Federal Reserve was seeking to achieve, the Fed would purchase the government's securities in order to bring rates back within their target range—in effect, expanding the supply of money and credit in the economy.

. . . Producing Excess Money Growth . . .

Chart II demonstrates what has happened to monetary growth over the past two decades as total Federal borrowing needs have risen. As you can see, there is a fairly close relationship between the trend in Federal borrowings and the long-run growth in the money supply, M-2. And since this is such a critical relationship, I am showing it to you another way—annual changes. Chart III presents the annual dollar changes in total Federal financing needs compared with annual percent changes in the money supply, M-2. Without getting technical, I can tell you that there was (until 1980) a pretty close link between the two, from a statistical standpoint—but you can see this for yourself in these charts.

CHART III
TOTAL FEDERAL AND FEDERAL-RELATED BORROWINGS (LINE) VS. MONEY SUPPLY M2 (DOT) (12 MONTH CHANGES)



. . . And Accelerating Inflation

The significance of the past relationship between Federal borrowing and money growth is its implication for inflation. In the words of Beryl W. Sprinkel, Under Secretary of the Treasury for Monetary Affairs: "A policy of monetizing the debt, designed to alleviate upward pressure or rises in interest rates, ignores the fact that increased money growth must accompany Federal Reserve purchases of government debt. Such money growth generates inflation and inflationary expectations. The Reagan Administration recognizes the connection among monetization of the deficit, money growth and inflation . . ."

To be sure, as Mr. Sprinkel went on to say, "There is no technical or legal reason for the Federal Reserve to monetize budget deficits." So those who say that a budget deficit (as well as the additional off-budget financings) need not *automatically* produce inflation (via excess money growth) are theoretically correct. However, I am not talking about theory—I am telling you the facts, and the facts are that the huge Federal financings of the past *did* lead to excess money growth because the Federal Reserve concentrated on achieving interest rate objectives. And excess money growth, as you can see from Chart IV, is closely linked with inflation.

One of the first rules one learns in algebra is that if two things are equal to the same thing, they are equal to each other. Expressed as a set of simple equations:

- *If A = B*
- *And B = C*
- *Then A = C*

I hope students of algebra will forgive me if I use this to describe the link that existed between Federal borrowings and inflation:

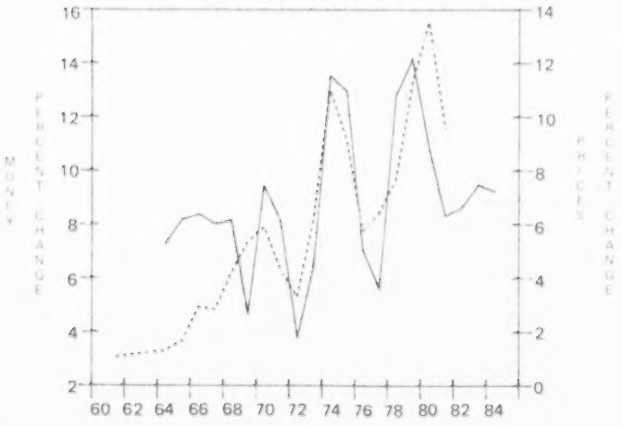
- If Federal borrowings caused excess money growth
- And excess money growth caused inflation
- Then Federal borrowings caused inflation.

Chart V shows that there *was* a link between the trend in Federal borrowings and the long-run trend in consumer prices. It was not as tight a relationship as the ones linking Federal financing to money growth or money growth to inflation because it was indirect. But it was there, nonetheless.

New Pressures Under Interest Rates . . .

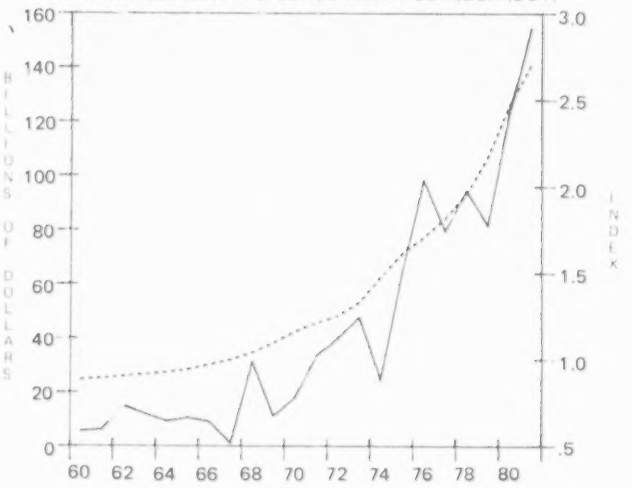
Today, of course, the link between Federal financing and inflation may no longer exist. This is because the Federal Reserve has stopped trying to control interest rates (which led to monetization of the debt) and has embarked on a course of attempting to control the monetary aggregates. Under this type of monetary policy, government financing will not result in the creation of new money but rather, the transfer of financial resources to the public sector from you and me in the private sector. This means there will be less money for business to borrow for capital spending, or for individuals to borrow to buy a house, car or any other big-ticket item.

CHART IV
MONEY SUPPLY M2 MOVED FORWARD 36 MONTHS (LINE) VS. CONSUMER PRICE INDEX (DOT) (12 MONTH CHANGES)



In these circumstances, real interest rates will remain high. This is because Federal financing by selling debt

CHART V
TOTAL FEDERAL AND FEDERAL-RELATED BORROWINGS (LINE) VS. CONSUMER PRICE INDEX (DOT)



securities adds to the demand for credit in the financial markets without there being a commensurate increase in credit supplies. Since the markets must clear—that is, demand must equal supply—and since sufficient supplies of credit will not be forthcoming, demand from the private sector must give way to public sector demands.

In markets free of controls, such as the financial markets, this process occurs by the price of money (interest rates) rising until enough private sector participants are "crowded out" i.e., decide that credit is too costly to borrow. Quoting Beryl Sprinkel one more time: "These are the adverse economic effects of a budget deficit: It bids up real interest rates, takes credit funds away from private borrowers, and re-allocates resources from the private to the public sector and thereby restricts economic growth. These effects are real and cannot be ignored."

. . . Will Curb Economic Growth

If you want further proof, just look at what high real interest rates did to the economy in 1981. Although interest rates as measured by the banks' prime lending rate twice before reached—or exceeded—20 per cent, they were not as onerous then as they were in 1981 because in real terms (adjusting for inflation) credit was not all that costly. I'll have more to say on this subject next month, when I go through my quarterly review of business conditions. For now, I hope I have convinced you that there *is* reason to be concerned that the existence of the government's huge financing needs will prevent the economy from enjoying healthy rates of real growth with reduced inflation and lower interest rates. M

Season's Greetings

...and a HAPPY NEW YEAR to all!

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The Manufacturers Hanover Economic Report

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Senior Vice President
and Economist

JANUARY 1982

Quarterly Business Conditions Analysis

What is intriguing about the economy's decline in the fourth quarter of 1981 is not that it is part of a new recession — the second recession in as many years, or even that it is a continuation of an up-down pattern that stretches back to early 1979. Rather, the significance of this downturn is how it began and what Washington is doing about it. More than any dissection of the fourth-quarter's GNP, an analysis of these two aspects of the current decline provides important clues regarding how deep it will go, when it will end, and what kind of recovery is in store.

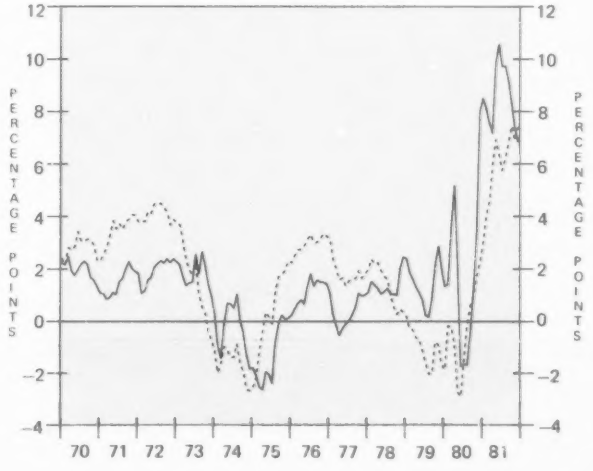
This is not to say that a close look at the fourth quarter's figures is totally unimportant. Indeed, one thing stands out that, if nothing else, suggests that the current decline still has some distance to go. Even though business slashed output at one of the fastest rates in recent memory, inventories continued to accumulate. Since excess stocks were the principal reason for the curtailment of production schedules in the first place, it is clear that further cutbacks lie ahead as business struggles to get stocks back into line with sales.

Nevertheless, the question must be answered concerning the reason why stocks grew excessively in the first place. One would assume that with the economy remaining as soft (and unpredictable) as it has for so many years — not to mention advances in inventory management and control thanks to widespread use of computers — businessmen would have erred on the side of caution when it came to monitoring levels of unsold goods. While many did, most were unprepared for the sudden drop in final sales that developed during the summer. In turn, this development traced to the high level that short-term interest rates reached late in the spring.

High Real Interest Rates ...

To be sure, it was not the first time that short-term rates had scaled these heights. The prime lending rate of the commercial banks, which reached 20½ percent last May, was even higher at the end of 1980 and the start of 1981, when it hit 21½ percent. And it first reached 20 percent back at the end of 1979. At that time, great concern was expressed that the economy would plunge into deep recession. After all, interest rates this high had not been seen in at least 100 years — if ever. After a couple of months, however, it became apparent that, as high as a 20 percent prime rate was, it was not as onerous as it seemed because the rate of inflation was high, too. Prices, as measured by the consumer price index, were rising at an annual rate of about 18 percent in the first quarter of 1980, while at the wholesale level, the annual rate touched 20 percent. This meant that the real cost of borrowing funds — the "real" interest rate — was not only not out of line with historical precedent — it actually disappeared before long (see Chart I).

CHART I
REAL PRIME RATE (LINE) VS.
REAL AA UTILITY RATE (DOT)



The level of real interest rates has great significance. When it is within "normal" range, it means that money costs can either be absorbed, or passed along. For the consumer, it is neither an incentive nor a deterrent to borrow. Thus, while nominal or quoted interest rates appeared high, in reality, when the equally high rate of inflation was taken into account, interest rates were not high at all. Thus, they did not pull the economy down as many had feared (or, in some cases, hoped). Of course, the real GNP did decline later on in 1980 — but that was due to another development that will be discussed later on.

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The decline in second-quarter 1980 pulled down interest rates but when the economy revived at midyear, interest rates soon followed. By yearend 1980 the prime again hit 20 percent — indeed, it reached an even higher level of 21½ percent. Again, fears developed for the economy, but again, these fears proved unfounded. This was because the rate of inflation, while down somewhat from earlier in the year, was still high enough to keep the "real" interest rate from reaching a level high enough to discourage borrowing, thus spending on goods and services. Indeed, first-quarter 1981's real GNP shot up at the fastest rate in three years.

Partly because of the associated jump in productivity (which offset rising labor costs, an important component of total business costs) and partly because of the earlier stagnation of the U.S. and other economies, the rate of inflation suddenly slowed. From 13 percent in fourth-quarter 1980, the consumer price index's rate of rise sank to 7½ percent in second-quarter 1981. Interest rates fell briefly, then rose again, with the prime rate, for the third time in about a year and a half, reaching the 20 percent zone.

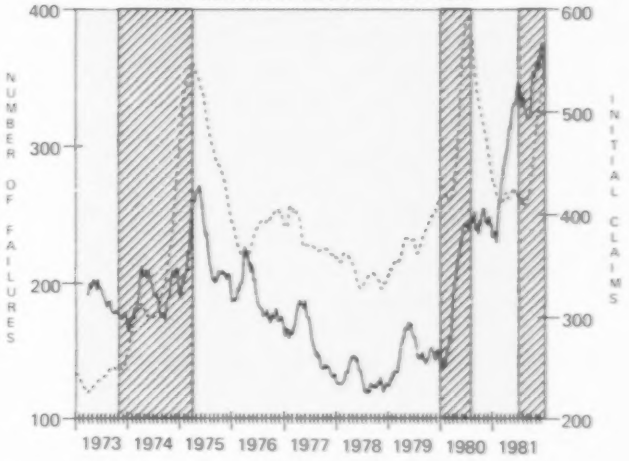
Interestingly, one fear disappeared and another arose. Since businessmen saw they could cope with this level of interest rates twice before, they greeted this third scaling of 20 percent with widespread indifference. Borrowing was not only not curtailed — it was stepped up. Fears of recession were nowhere to be seen among a business and banking community very much impressed with the Administration's proposed economic program. Indeed, the casual air surrounding last spring's level of interest rates led some analysts to express concern that the economy had "learned to live with high interest rates."

... Put the Kibosh on the Economy

Such concerns proved to be as erroneous as the earlier ones dealing with the belief that high nominal rates were about to push activity down. For even as businessmen were sure that they could live with these rates, a growing number found that they could not. This is because the much-reduced rate of inflation referred to above turned high but familiar nominal interest rates into unprecedented real interest rates. A 20½ percent prime rate with a twelve-month inflation rate of 10 percent or less implied a real cost of borrowing money of over 10 percent. This proved to be the straw that broke the economy's back.

Before the summer was too old, a number of businesses found that they could neither absorb such a high real cost, nor pass it along. (A low inflation environment means any price increase tends to stand out more than would be the case in a period of rapidly rising prices.) One by one, companies closed their doors. Business failures shot up and before long were running 45 percent above the year before (see Chart II). Not surprisingly, orders for merchandise were cancelled, causing goods produced but unsold to pile up. These two developments led to a sudden jump in layoffs; the unemployment rate went from seven percent in July to eight percent three months later.

CHART II
BUSINESS FAILURES [LINE] VS. INITIAL UNEMPLOYMENT INSURANCE CLAIMS (000) [DOT]
THIRTEEN WEEK MOVING AVERAGES



As people lost their jobs, their confidence in the outlook began to erode — not to mention their buying power. Retail sales softened just at a time when merchants had ordered extra goods in anticipation of higher Holiday sales. When these great expectations failed to materialize, retailers retrenched, causing further increases in unsold goods and pressures on production schedules. You can see how this became a circular process, producing the decline in the economy reported for the fourth quarter of 1981, and laying the groundwork for a further drop in the current quarter.

Although the proximate cause of the current decline in economic activity — the need to reduce excess inventories — is not dissimilar from that which caused previous slides, the ultimate cause, high real interest rates, was different. Past declines — at least stretching back to the mid-1960's — were caused by a phenomenon known as a "credit crunch." This was a period in time — however brief — when money was unavailable at any price, no matter how big or creditworthy the borrower. It was such a crunch that sent the economy down in second-quarter 1980 as businessmen, consumers and bankers misinterpreted the Federal Reserve's credit controls to mean that borrowing was to be *severely* curtailed. The steepest part of the 1973-75 recession began in September, 1974, after the banks had cut back their lending as political pressures kept them from raising their prime rates high enough to cover their incremental money costs. Similar crunches led to the recession of 1970 and the mini-slump of late 1966-early 1967.

Economic Policy Remains Tight ...

The other major difference between the current decline and declines past is the reaction of policymakers

at the Federal Reserve, in the Administration and the Congress. In the past, whenever evidence of a drop in economic activity became apparent, Washington policymakers would leap into action. The Fed would push interest rates down and inject additional funds into the economy in order to encourage borrowing, investing and spending. On the fiscal side, spending would be cranked up, while talk of tax cuts would become rife. This time, things are different, and it is these differences in Washington's response to the decline, along with its unique cause, that will shape the economic and financial outlook for the balance of this year, and, quite possibly, 1983 as well.

As far as fiscal policy is concerned, the tax cuts that were enacted last year should not be considered anti-recession in nature. For one thing, they were designed to encourage personal saving and corporate investment, neither of which produces more spending, as an immediate prospect. And while the Administration *now* considers the personal tax cuts anti-recessionary, they are, or will soon be, offset by: (1) higher Social Security taxes that took effect January 1; (2) the effects of inflation, however reduced, as it pushes us all into higher tax brackets; (3) the growing incidence of state and local governments raising their taxes. On the spending side, if anything, the pressures are to cut — not increase.

Monetary policy is different as well. The Federal Reserve is not only not attempting to push interest rates down, it is not even being overly generous with the money supply — its primary objective. Last year the Fed undershot its growth targets for M-1 for the first time since they were first made public in 1975. What is more, as long as the Fed concentrates on money supply objectives, any increase in real economic activity will produce an immediate jump in interest rates. To run assembly lines faster, business will require more working capital, which will put it in competition with the Treasury for a limited supply of loanable funds. Plainly, rising interest rates from today's still high levels will not permit any economic recovery to last long.

... So the Real GNP Will Go Nowhere

With this in mind, let us examine the economic and financial outlook for 1982. The table on the back describes an economy in 1982 not very different in top-line real GNP respects from its predecessors in 1981, 1980 and 1979. Real growth may reappear before mid-year, but it is unlikely to be long-lasting. By yearend, the economy may well be falling once again. This scenario is based on several assumptions which are spelled out at this time. First, it is assumed that the Federal government will continue to be a huge borrower of funds — regardless of whether the reported deficit in Washington's budget amounts to $109 billion, $100 billion, $80 billion or whatever. As readers of this Report will recall (see November and December 1981), Washington's financing needs are far greater than that suggested by the deficit alone. Second, it is assumed that the Federal Reserve will stick to its current monetarist-oriented monetary policy and more or less ignore changes in the demand for funds. Such a policy, as noted above, produces volatile interest rates that rise at the slightest hint of more demand.

As nominal interest rates rise, real interest rates will move up even faster. This is because the rate of inflation is expected to recede further, due to ample supplies of foods and fuels, smaller wage increases (and more labor givebacks), soft commodities' prices worldwide, declining mortgage rates and home prices, and, of course, tight money. Since the economy has clearly demonstrated that it *cannot* live with high real interest rates, any rise that does occur will be brief and self-limiting: Business will contract, the demand for funds will shrink, and interest rates will fall again.

Thus, while interest rates will continue to be volatile (as they must, when the Federal Reserve concentrates on managing the supply of money rather than its price) and may well rise later this year as the current slide ends, they don't appear likely to scale new heights. In addition, as noted above, the rate of inflation should continue to slow. These salutory developments, however, will be weighed by the politicians and their various constituencies against unemployment, whose rate undoubtedly will soon reach a new postwar high, and whose actual numbers can already be compared with the end of the Great Depression. The implication here is that political pressures may alter the scenario described above.

Even now, such pressures have descended upon the Federal Reserve. It is becoming increasingly difficult to find a businessman, commercial banker, or "man on the street" who still expresses 100 percent support for the central bank's monetary policy. The Congress has long been critical of the Fed; recently, the Administration joined the fray. What this means is that the Federal Reserve may decide to change some of its tactics, since, like the Supreme Court in the Roosevelt era, it reads the newspapers. What these changes are and how they are received by the financial markets will be a key factor in 1982's economic and financial outlook.

If the Fed stands fast, 1982 will be an uncomfortable year for politicians who have to run on this year's record. Unemployment will be high; sales and profits low. But inflation will recede and interest rates should eventually get down to the point where a more sustained recovery (*after* Election Day 1982) can get underway. If the Fed gives in and expands the supply of money and credit enough to push interest rates down relatively quickly, the "real" economy may look somewhat better — but at the possible cost of rekindling inflation and the expectation of inflation. This means eventually even higher interest rates and a poorer outlook for 1983. I think the Fed will resist these pressures, but we won't know for sure for several more months. H

January, 1982

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

			< ACTUAL						PROJECTED >					
	YEAR 1980		1981				YEAR 1981		1982				YEAR 1982	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	**2626.1**	**8.8**	2853.0	2885.8	2965.0	2984.9	**2922.2**	**11.3**	3006.5	3078.3	3140.6	3195.6	**3105.2**	**6.3**
GNP: $72	**1480.7**	**−0.2**	1516.4	1510.4	1515.8	1495.6	**1509.5**	**2.0**	1488.5	1493.8	1506.6	1502.6	**1497.9**	**−0.8**
% Change, Annual Rates	**−0.2**		8.6	−1.6	1.4	−5.2	**2.0**		−1.9	1.4	3.5	−1.1	**−0.8**	
Consumption	**1672.7**	**10.7**	1810.1	1829.1	1883.9	1909.5	**1858.1**	**11.1**	1947.4	1993.8	2027.9	2067.1	**2009.0**	**8.1**
Durables	**211.9**	**−0.2**	238.3	227.3	236.2	226.4	**232.0**	**9.5**	237.7	245.9	250.8	252.7	**246.8**	**6.4**
Non-Durables	**675.7**	**12.2**	726.0	735.3	751.3	760.9	**743.4**	**10.0**	765.8	774.8	783.9	797.5	**780.5**	**5.0**
Services	**785.2**	**12.8**	845.8	866.5	896.4	922.2	**882.7**	**12.4**	943.9	973.1	993.2	1016.8	**981.7**	**11.2**
Investment	**395.3**	**−4.9**	437.1	458.6	463.0	443.6	**450.6**	**14.0**	424.0	443.4	461.0	453.7	**445.5**	**−1.1**
Non-Residential	**295.9**	**5.8**	315.9	324.6	335.1	332.6	**327.1**	**10.5**	330.9	333.7	337.7	336.1	**334.6**	**2.3**
Producers Durable Equipment	**187.1**	**2.0**	198.7	201.5	206.8	201.2	**202.0**	**8.0**	201.6	204.4	210.7	206.6	**205.8**	**1.9**
Structures	**108.8**	**13.0**	117.2	123.1	128.3	131.4	**125.0**	**14.9**	129.3	129.3	126.9	129.5	**128.7**	**3.0**
Residential	**105.3**	**−11.2**	116.7	110.7	100.5	93.4	**105.3**	**0.1**	93.9	107.2	120.1	117.4	**109.7**	**4.1**
Inventory Changes	**−5.9**		4.5	23.3	27.5	17.6	**18.2**		−0.8	2.5	3.2	0.2	**1.3**	
Net Exports	**23.3**		29.2	20.8	29.3	16.0	**23.8**		15.8	14.1	15.2	18.5	**15.9**	
Government Purchases	**534.7**	**12.9**	576.5	577.4	588.9	615.7	**589.6**	**10.3**	619.2	626.9	636.6	656.3	**634.7**	**7.7**
Federal Defense	**131.7**	**18.4**	145.2	148.2	154.1	165.8	**153.3**	**16.4**	169.9	173.1	177.7	196.0	**179.2**	**16.9**
Federal Civilian	**67.2**	**18.5**	76.4	71.3	72.2	81.0	**75.2**	**11.9**	75.6	77.3	78.7	76.9	**77.1**	**2.5**
State & Local	**335.8**	**9.8**	354.9	357.9	362.5	369.0	**361.1**	**7.5**	373.7	376.5	380.2	383.5	**378.5**	**4.8**
Final Sales: $72	**1483.6**	**0.7**	1517.8	1499.6	1500.9	1487.1	**1501.4**	**1.2**	1488.6	1492.8	1505.4	1502.6	**1497.3**	**−0.3**
% Change, Annual Rates	**0.7**		6.9	−4.7	0.3	−3.6	**1.2**		0.4	1.1	3.4	−0.7	**−0.3**	
GNP Price Index (1972 = 100)	**177.4**	**9.0**	188.1	191.1	195.6	199.6	**193.6**	**9.1**	202.0	206.1	208.5	212.7	**207.3**	**7.1**
% Change, Annual Rates	**9.0**		9.8	6.4	9.9	8.4	**9.1**		4.9	8.3	4.7	8.4	**7.1**	
PCE Deflator (1972 = 100)	**178.9**	**10.2**	188.5	191.5	195.7	199.3	**193.8**	**8.3**	201.8	205.6	207.9	211.3	**206.7**	**6.7**
% Change, Annual Rates	**10.2**		8.0	6.5	9.1	7.6	**8.3**		5.1	7.8	4.6	6.7	**6.7**	
Consumer Price Index (1967 = 100)	**247.0**	**13.5**	263.6	268.4	276.1	281.3	**272.4**	**10.3**	284.9	289.6	293.6	298.0	**291.5**	**7.0**
% Change, Annual Rates	**13.5**		10.8	7.5	11.9	7.8	**10.3**		5.2	6.8	5.6	6.1	**7.0**	
Total Personal Income	**2160.3**	**11.1**	2319.7	2368.5	2441.7	2484.4	**2403.6**	**11.3**	2511.9	2578.1	2626.3	2681.4	**2599.4**	**8.1**
Disposable Personal Income	**1821.7**	**11.0**	1947.8	1985.6	2042.0	2086.4	**2015.5**	**10.6**	2111.7	2163.5	2234.0	2277.1	**2196.6**	**9.0**
Savings Rate	**5.6**		4.6	5.4	5.2	6.0	**5.3**		5.2	5.3	6.7	6.6	**6.0**	
Employment Rate	**57.7**		57.7	58.0	57.7	57.0	**57.6**		56.7	56.7	56.8	56.9	**56.8**	
Unemployment Rate	**7.1**		7.3	7.4	7.2	8.4	**7.6**		9.2	9.4	9.4	9.5	**9.4**	
Indus. Production (1967 = 100)	**147.0**	**−3.6**	151.8	152.5	153.0	146.3	**150.9**	**2.6**	144.1	145.1	148.3	148.5	**146.5**	**−2.9**
Housing Starts (000)	**1303.5**	**−24.0**	1390.7	1176.3	968.0	902.7	**1109.4**	**−14.9**	1021.6	1224.1	1272.7	1324.5	**1210.7**	**9.1**
Domestic Auto Sales (000)	**6595.8**	**−19.9**	7400.0	5566.7	6933.3	5184.0	**6271.0**	**−4.9**	6382.2	6782.3	7120.4	6731.2	**6754.0**	**7.7**
Corporate Pre-Tax Profits	**245.5**	**−3.8**	257.0	229.0	234.4	205.8	**231.6**	**−5.7**	180.4	188.9	209.4	208.2	**196.7**	**−15.0**
− Taxes	**82.4**	**−6.0**	87.7	76.4	78.1	66.6	**77.2**	**−6.3**	55.0	58.3	66.1	66.0	**61.3**	**−20.5**
Net Profits	**163.2**	**−2.7**	169.2	152.7	156.3	139.2	**154.4**	**−5.4**	125.4	130.7	143.3	142.2	**135.4**	**−12.3**
− Dividend Payments	**56.0**	**11.7**	59.6	62.0	64.8	66.0	**63.1**	**12.7**	67.3	69.2	72.1	75.4	**71.0**	**12.5**
Undistributed Profits	**107.2**	**−8.9**	109.6	90.6	91.5	73.2	**91.2**	**−14.9**	58.1	61.4	71.2	66.9	**64.4**	**−29.4**
+ Depreciation	**158.3**	**13.4**	172.8	179.9	187.7	194.9	**183.8**	**16.2**	211.1	216.4	221.9	227.5	**219.2**	**19.3**
− Inventory Profits	**45.6**	**7.1**	39.2	24.0	25.3	20.9	**27.4**	**−40.1**	16.6	29.1	31.0	35.5	**28.0**	**2.5**
Net Cash Flow	**219.8**	**2.4**	243.2	246.5	253.9	247.2	**247.7**	**12.7**	252.7	248.7	262.1	258.8	**255.6**	**3.2**

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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FEBRUARY 1982

CRA Is Not The Way

The failure of interest rates to fall in the face of deepening recession, growing financial strains in the private sector and a much-subdued rate of price inflation has, quite understandably, led to a lot of finger-pointing. Most of this appears to be aimed in the direction of the Federal Reserve, in the belief that it must bear the ultimate responsibility for the availability of money and its price in the United States.

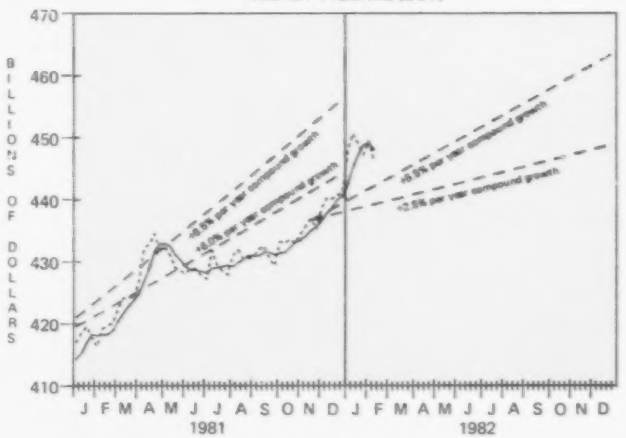
Complaints are being levied that the Fed's inability to promote stable growth in the supply of money and credit has produced such erratic interest rates that the financial markets have added a sizable volatility premium to the "real" rate of return they usually demand for investing funds, besides their expectations about inflation. In turn, these high "real" interest rates are making it increasingly difficult for businesses to borrow, since they can neither absorb these costs, nor pass them on. Additionally, they present an unusually high "hurdle" rate that must be surmounted before any thought of capital spending — the sine qua non for revitalizing the private sector — can take place.

Thus, in order to get financial market participants to lower the volatility premium now embodied in both short- and long-term rates, a number of observers have begun to offer advice to the Federal Reserve concerning how to stabilize money growth (Chart I). Not the least of these is President Reagan's Council of Economic Advisers. In its Annual Report for 1982, the Council asserts that the Federal Reserve would be able to exercise greater control over the monetary aggregates by switching from lagged reserve accounting (LRA) to contemporaneous reserve accounting (CRA). Let us examine this proposal to see if it, indeed, would help reduce monetary volatility.

The Role of Reserves

To enhance the Federal Reserve's ability to control the nation's supply of money and credit, commercial banks and other depository institutions must hold some of their assets in the form of reserves. These reserves can consist of vault cash or deposits at a District Federal Reserve Bank. Their size is determined by the average level of deposit liabilities the banks had on hand two weeks earlier — hence the term "lagged reserve accounting." They consist of two types: nonborrowed, which are owned outright by the banks and are acquired through Federal Reserve open market operations; and borrowed, which are obtained via a loan from the discount window of the Fed. To effectively control money growth, the Federal Reserve must be able to control *both* components of member banks' reserves — nonborrowed and borrowed.

CHART I
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE) VS.
WEEKLY FIGURES (DOT)



Those who advocate a change (actually, a return) to CRA believe that such a system would improve the Fed's ability to control growth of the money supply. This is because it would allow open market operations of the Fed to have a more immediate effect on total bank reserves — especially important because the Fed has been trying to target reserves since October, 1979.

Under LRA, the banks' levels of required reserves are determined by deposits held two weeks earlier. By law, the member banks in the system must be able to come up with their required reserves. In the short run, all the Federal Reserve can do is determine how these reserves are composed — either borrowed or non-

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borrowed. CRA advocates feel that the Fed's ability to influence total reserves in the banking system is constrained by the LRA system. In the very short run, the Fed is, in effect, a passive supplier of reserves either through open market operations or the discount window — in effect, validating portfolio and asset decisions already made by the commercial banks.

If the Fed wanted to alter monetary policy — say in the direction of slower growth of money — the LRA system delays the receipt of this signal by the banks. By the same token, the banks' reaction can be delayed as well. Because of these lags, CRA advocates assert that the Fed's control over the money supply has been erratic over periods of time as long as several months. And because the Fed releases these data weekly, financial market participants are able to plot them against the central bank's stated targets for growth thus jumping to conclusions in one week which may be reversed the next. This has allegedly produced a good deal of the volatility we've seen in interest rates of late and is supposedly responsible for the failure of interest rates to fall during a period of recession and reduced inflation.

These arguments sound mighty compelling — especially since money growth has not been stable. The question is — will a return to CRA enhance the Fed's ability to control the money supply and what costs would be involved in the process?

Plusses and Minuses

In my view, there is little to be gained from a change toward CRA — but a lot that could be lost in the form of greater uncertainties and increased volatility in the financial markets. First of all, CRA won't change the fact that the banking system cannot fail to meet its legally binding reserve requirements. If the banks can't obtain needed reserves in the Federal funds market, they must turn to the Fed and borrow at its discount window. As the banking system's only source of reserves, the Fed cannot avoid satisfying banks' needs for reserves. This is the case today, under LRA, and it would be the case under CRA as well.

The only difference under CRA is that both the banks and the Fed would have less time to adjust to changes in the banking system's needs for reserves. This would lead to more volatility and uncertainty in the money markets. And while CRA had been used until 1968, in those days, the Fed's policy was to manage interest rates, thus smoothing out financial market volatility. Today, because the Fed no longer pays much attention to interest rates, markets are already volatile, thus any shift toward CRA would only exacerbate the situation.

While adopting CRA might reduce somewhat the tendency of the banks to "force" the Fed to supply reserves required to support portfolio and asset decisions made two weeks earlier, this could backfire for several reasons. First, to the extent sudden asset adjustments have to be made (i.e.: fewer loans or reductions in credit lines), the banks will lose even more of their lending business to other markets (commercial paper, foreign banks, etc.) than they already have. This, in turn, would loosen, rather than tighten, the Fed's control over monetary policy, and monetary policy's relationship, in turn, with aggregate economic activity, inflation, etc.

Second, to forestall such unpredictability (which would anger not only their customers, but the banks' own lending officers as well), bank senior managements would probably decide to hold excess reserves with the Fed. This would give them leeway to avoid making sudden asset shifts, but would cut into their profitability — not to mention the Fed's control over the aggregates. Third, as long as reserve requirements vary among different categories of bank deposits and other non-deposit liabilities, there is nothing in CRA that would prevent the banks from changing the composition of their liabilities in order to free up reserves. This could be accomplished by intentionally offering their customers incentives to shift deposits. Such shifts may also result from wholly independent actions of the non-bank public for reasons that neither the banks nor the Fed can anticipate.

This brings to mind another argument against CRA — the fact that, in the short run, the Fed's control over the money and reserve aggregates could be altered by actions taken by commercial banks, the non-bank private sector, and the Treasury. Commercial bank reserve demands can be unexpectedly affected by changes in such operating factors as currency in circulation, "float" and Treasury balances at the Federal Reserve banks — the impact of which even the Fed is unaware of, at times, until after the fact. This will not change under CRA; as a result, with CRA unanticipated reserve supply developments will not only continue to produce severe interest rate instability — their impact could be quicker as well as more pronounced, since they would not be dampened by timely open market operations.

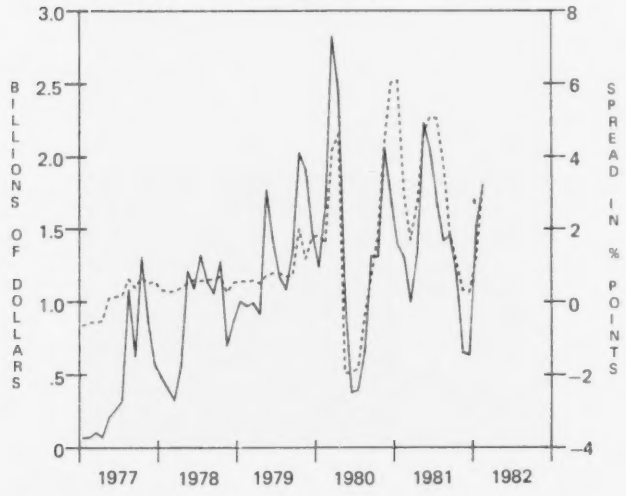
The Fed's control is also limited by the fact that the basic data that the Federal Open Market Committee uses to influence money are unadjusted while the money figures that everyone follows is seasonally adjusted. As the Boston Fed recently warned: "Seasonal patterns in money demand and supply and in uncontrolled factors that affect reserves sometimes change abruptly." To this I would add: it is virtually impossible to set weekly seasonal patterns for any statistic — much less for money, where random events (weather, politics, international developments, mass psychology,

etc.) overwhelmingly determine liquidity preferences of the non-Fed factors, thus changes in the money supply.

On the subject of weekly data, no serious economist thinks for one moment that weekly fluctuations in the money supply mean anything. For one thing, the magnitude of the changes in initially-reported figures frequently differ when revisions are made. For another, many times these changes are reversed in a subsequent week's report. Furthermore, the link between money and the economy — velocity — tends to fluctuate widely and unpredictably. The aggregates, themselves, take on new and unforseeable meaning whenever laws, technology, and sophistication change — which happens too frequently these days. Less volatility could be achieved simply by the Fed issuing monetary statistics less frequently.

Finally, a couple of points to ponder. First, notwithstanding its problems with LRA, velocity, portfolio shifts, seasonal adjustments, and the like, most economists believe that the Fed did a pretty good job of controlling money in 1981. MIB growth wound up the year slightly below the Fed's target, but M2 was slightly above, so, given the problems noted above, it would appear that, on average, the targets were hit. Second, if even greater short-run control is desired, the Fed need not go to CRA. It need only adopt a floating discount rate pegged at a *penalty* level (say, 50 basis points) above the Federal funds rate as proposed in

CHART II
MEMBER BANK BORROWINGS (LINE) VS. THE SPREAD BETWEEN THE FED. FUNDS AND DISCOUNT RATES (DOT)



the Manufacturers Hanover Economic Report of December, 1980. In this way, member bank borrowing would respond sooner to Fed tightening, since the opportunity to obtain reserves at a below-market rate would no longer exist.

As you can see from Chart II, the Fed's ability to control money growth has been hampered by the activities at its discount window. The bigger the spread between the Federal funds rate and the discount rate, the more member banks have sought to satisfy their reserve requirements by borrowing from the Fed. Thus, notwithstanding whatever reductions in nonborrowed reserves the Fed may have aimed for in its open market operations, control over total reserves was less effective than it could have been because of the existence of this "escape valve."

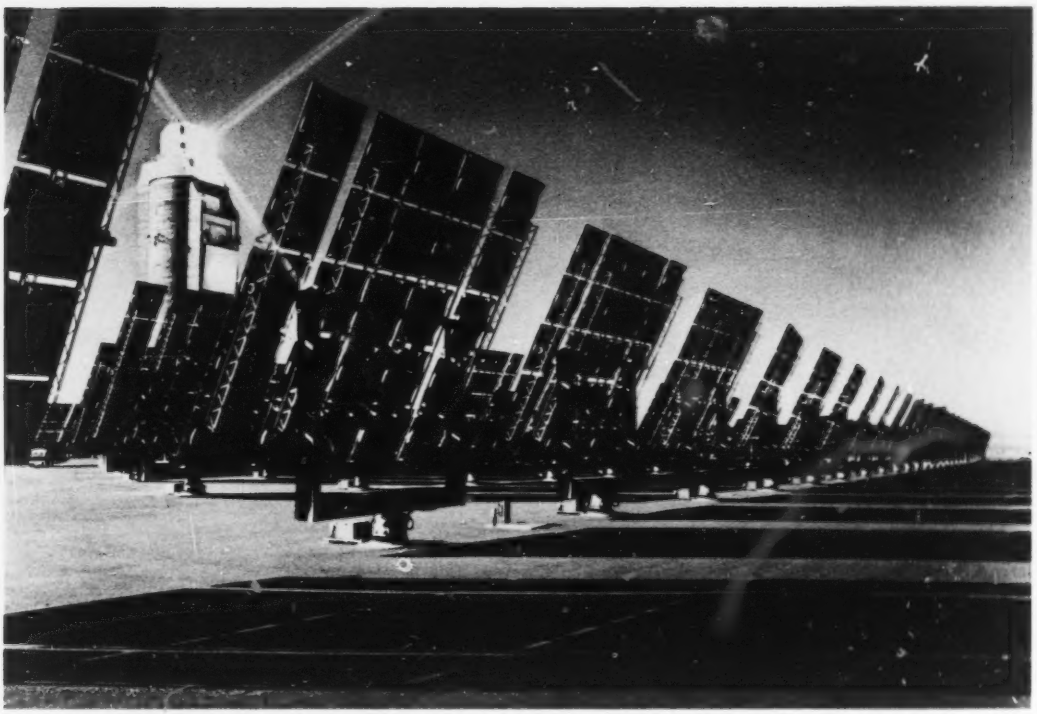
It would therefore appear that the institution of a floating discount rate, rather than a return to CRA, might be all that would be needed for greater control over total bank reserves, hence over money growth. As for CRA, the Federal Reserve Bank of Kansas City, in an exhaustive econometric analysis, recently concluded that "returning to CRA would not appreciably improve the precision of short-, medium-, or long-run monetary control under the nonborrowed reserves operating procedure now being employed by the Federal Reserve." Furthermore, the Bank believes, "a return to CRA accompanied by the adoption of a total reserves operating procedure would *worsen* (italics mine) monetary control."

Fiscal Policy's at Fault

Having said all this, I must conclude by pointing out that no amount of control over money — no matter how precise — can be any more than marginally helpful in reducing interest rates and promoting healthy economic growth so long as the Federal government continues to run large and growing deficits (both on-and off-budget). The Federal Reserve may no longer be monetizing these deficits, but, as Fed Governor Henry Wallich recently pointed out, even non-monetized deficits lead to high rates of inflation — not to mention high interest rates.

Another impediment to lower rates is a fear among market participants that a continuation of the present conflict between the irresistible force of Federal government borrowing and the immovable object of a monetarist-oriented tight money policy by the Federal Reserve might lead to a wave of bankruptcies which would force the central bank to compromise its money growth objectives by acting as lender of last resort, in order to save the financial system. In other words, before monetary policy can even begin to effectively improve economic conditions, fiscal policy must change: Washington's budget deficit must be reduced — not widened as now seems likely.

The finger of blame should be directed at fiscal — not monetary policy. H



Solar testing facility near Albuquerque, New Mexico.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

MARCH 1982

What Ails Us?

The U.S. economy is not afflicted with an incurable ailment. If we did suffer from a prolonged illness, it was inflation. The rate of increase in consumer prices climbed from 1.3 percent during the first half of the 1960s to 4.3 percent in the second half; 6.8 percent in the first half of the 1970s; 8.9 percent in the second half, winding up with prices rising 10.3 percent in 1981. However, most of 1981's inflation occurred early in the year: since October, consumer prices have risen at an annual rate of less than five percent. What is more, wholesale prices, which tend to lead changes in consumer prices, actually fell in February — the first monthly decline in six years. We may not have cured our inflationary malady — but we sure have eased the pain.

In spite of this breakthrough, the economy remains sick; its citizens concerned. With business failures and unemployment reaching levels not seen since the 1930s, talk of depression has begun to fill the air. We are obviously suffering from something, but what is it?

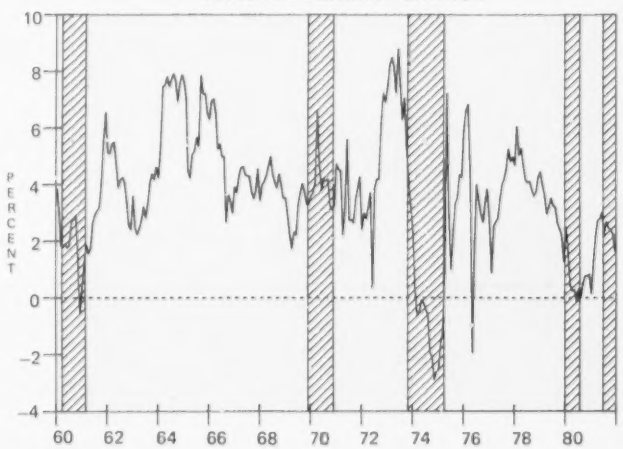
Consumers Are in Good Shape . . .

Let me tell you what is *not* causing today's ills — an overextended consumer. With the exception of two big-ticket items which I will discuss shortly, autos and housing, people's aggregate ability to purchase goods and services is about as good as it's ever been. This is vital, because consumer spending accounts for two-thirds of our economy. Let us look at the various determinants of consumer spending to see why this is the case.

A person's ability (and willingness) to spend will depend, first of all, on whether he or she has a job, then, on what that income can buy. Of course, this can be supplemented by borrowing or liquidation of existing assets, including drawdowns from savings. In terms of employment, it should be noted that, notwithstanding the large number of people out of work or even the high jobless rate, the number of people *with* jobs is up, too. In February, over 99½ million people were at work. This is only 1½ million short of the all-time record of 101 million jobholders set in May, 1981. Compared with the total population over 16, February's employment equals 57.3 percent — well above the postwar average of 55.8 percent.

Of course, those levels of employment would be only partially helpful unless the incomes they generate permitted people to buy the goods and services they wanted. Thus, it is necessary to look at buying power — what after-tax incomes will buy when inflation is factored out. While there have been times when buying power was growing faster than it is today, there have also been times when it was contracting, as you can see from Chart I. The point is — people's buying power *is* growing some two percent per annum and in the past, that was enough to produce spending gains sufficient to propel the economy forward.

CHART I
REAL DISPOSABLE INCOME
12-MONTH PERCENT CHANGE



Even more important is the fact that people can tap their credit lines, if they wished, to supplement this buying power. For a variety of reasons — recessions, reduced purchases of autos and household goods, and the aftermath of the 1980 credit controls — the percent of take-home pay required to service installment debt has fallen to one of its lowest levels in about 15 years, as you can see from Chart II. As a corollary, only 30 percent of retail sales are made today with the aid of credit; two years ago the percentage was nearly 40.

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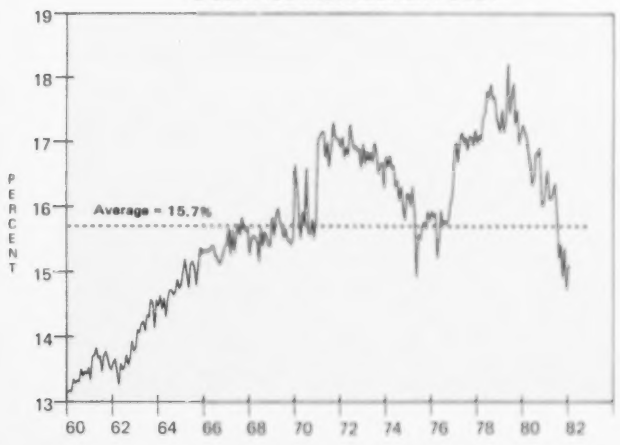
If people are leery of going into debt because of all the discouraging words they read and hear these days, they can always turn to the assets they already own. Whether you look at them in current dollars, or after adjustment for inflation, household liquid assets (defined as cash, savings accounts, money market funds and Treasury securities) are at record levels (Chart III). In particular, personal savings today total $120 billion — more than twice levels recorded as recently as five years ago!

Before going any further, I feel constrained to discuss the two major products whose accessibility appears to have moved away from consumers — autos and housing. These are the two biggest purchases the average person will ever make; they also represent the two industries whose fortunes very much affect the economy (and vice versa). Unfortunately, for reasons that predate the current recession, these two industries have been ill for quite some time — and do not appear likely to recover anytime soon.

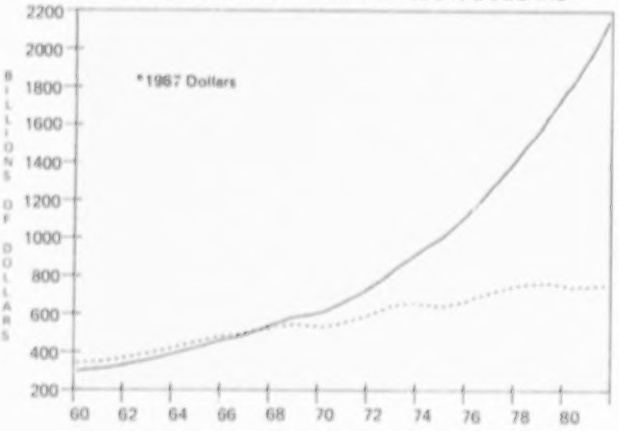
I suppose autos and housing both fell ill shortly after the 1973 oil embargo and subsequent jump in the price of energy. Both had previously grown to great economic importance because energy (gasoline, heating oil and natural gas) was plentiful and cheap. Once this ceased to be the case, it reduced the attractiveness of single-family homeownership in remote areas, far from work, shopping and schools. People began looking for houses "close in," which caused a runup in prices as "desirable" land became scarce. Meanwhile, auto-makers found they had to invest huge sums to make cars more energy efficient. The net result was that prices of both autos and housing rose sharply — faster than most other prices and most families' incomes.

CHART II
PERCENT OF DISPOSABLE INCOME NEEDED
TO SERVICE INSTALLMENT DEBT



This alone sent autos and housing into sick bay. When combined with the runup in interest rates of the past few years, their condition took a turn for the worse. In the case of housing, no recovery is likely until mortgage interest rates come down. For at today's levels of housing prices, interest rates and family incomes, some 85 percent of all households are priced out of the new-home market. By contrast only 40 percent could not afford to buy a new home in 1975 — just before housing starts embarked on a rise that saw them doubling in two years. As for autos, besides the issue of quality, price seems to be the major deterrent. Monthly payments on the average car sold in the U.S. now require 15 percent of a typical family's income to be set aside, compared with ten percent seven years ago and most of this jump traces to higher prices.

CHART III
HOUSEHOLD LIQUID ASSETS OUTSTANDING
CURRENT (LINE) AND REAL* (DOT) DOLLARS



. . . But Business is Not

The condition of these two industries might have a good deal to do with the lack of growth in industrial output over the past four years, but they don't explain the recent sudden rash of business failures and talk of depression that permeates the land. To be sure, many business casualties are related — directly or indirectly — to housing and autos. But the recent rise — as well as the general trend of the past — seems to trace to high interest rates. Chart IV shows that there appears to be a correlation between inflation-adjusted interest rates and business failures with about six months being the time when business feels their full impact. The relationship today appears to be closer than in the past because of the increased reliance on debt on the part of business.

Although in part the result of deliberate efforts to manage cash efficiently in a period of inflation and high interest rates, today's corporate debt levels have reached a point where they have become self-perpetuating. This means that what might have been desirable several years ago has now become a problem. Because of the recent uptrend in interest rates, large blocks of investment funds were channeled into fixed income obligations, causing stock prices to decline and the raising of equity capital to become impractical. As bond market rates rose into the teens, companies began to concentrate their borrowing in the short-term area, hoping to avoid locking themselves into high rates for long periods of time. And, of course, the more funds

were borrowed short, the more borrowing had to take place because the debts matured more often.

When inflation was high, business found it could afford to pay high interest rates. But once inflation receded, high interest rates became very costly (see January's Economic Report). Since they could not absorb these high real money costs, nor easily pass them on in a reduced-inflation environment, business began closing its doors at rates which soon began to compare with the 1930s. This takes us to the present, and the talk of depression.

Obviously, conditions would change for the better if real interest rates were to come down. Unless inflation flares up, this process must involve a drop in nominal rates. I observed last month that there were several reasons why interest rates have failed to come down in the face of reduced inflation and deeping recession. One was concern over the Federal Reserve's ability to manage the money supply. I regard this as a minor factor. More important is the growing borrowing needs of the Federal government, as evidenced by deficit projections that are constantly being raised upward and outward into the future as far as the eye can see. Because the Federal Reserve is no longer following a policy of replacing the funds that Washington borrows, and because the private sector's demand for funds remains strong for reasons described above, interest rates have remained high. Yet, higher interest rates in the context of reduced inflation are driving more and more companies to the brink. The status quo can't be tolerated much longer; something must be done.

Lower the Deficit . . .

From here, it would appear that the major source of today's economic woes is fiscal policy. The government's deficit is simply too large and must be brought down in a meaningful and credible way. This can be accomplished either by cutting spending across the board and/or restoring tax revenues. I use the term "restoring revenues" as opposed to "tax increase," which some Administration officials have begun using pejoratively.

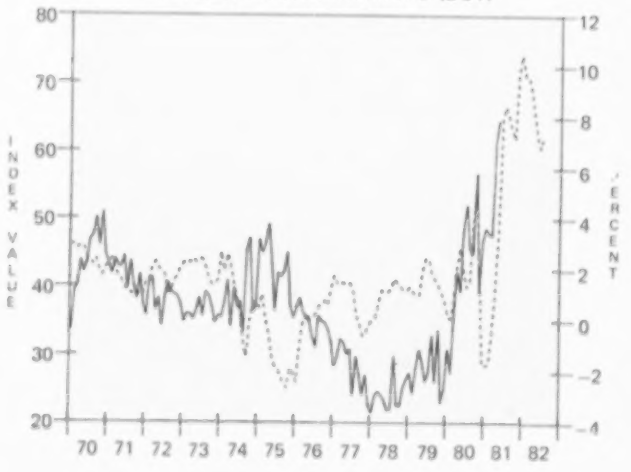
The original reason for cutting tax rates was to raise revenues enough to help finance Washington's deficit, increase defense spending, yet leave enough for business to tap in order to increase plant and equipment investment. This clearly has not worked—a fact that is admitted by the Administration in its 1983 budget document: "The Economic Recovery Tax Act (ERTA) of 1981 . . . is estimated to *reduce* (italics mine) receipts by $38.3 billion in 1982, $91.6 billion in 1983, $139 billion in 1984 and $176.7 billion in 1985."

Still committed to the tax cut, the Administration appears to have adopted a new strategy: using the current and projected budget deficits as a means of pressuring Congress to cut outlays (obviously non-defense). This may not meet with much success, either. Most citizens may be in favor of a balanced budget, but they have little enthusiasm for the cuts in Federal spending that they personally would have to endure in order to accomplish this goal. People are in favor of tightening belts — as long as it is someone else's, not theirs. So whatever cuts can be sweated out of the budget are unlikely by themselves to make more than a small dent in the deficit.

This leaves revenue restoration — an idea whose time has come. People have demonstrated in the past that they are ahead of their elected officials and today is no exception. Notwithstanding the hubris exhibited by some members of the Administration whenever talk of rescinding the tax cut arises, it is clear that the people want this — and would actually benefit as a result!

A recent survey taken by *Newsweek* bears this out. The magazine reports that 70 percent of those polled would be willing to postpone scheduled income-tax cuts in order to reduce the budget deficit. Calculations made by this Bank based on data supplied by the Congressional Budget Office (CBO), the Commerce Department plus standard mortgage payment tables reveal that whatever would be lost in the form of the foregone tax cut, would be more than made up if the result was a drop in interest rates. Remember — it is not an overextended consumer that is responsible for this recession — it is high *real* interest rates and their impact on business and consumer confidence.

CHART IV
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE) VS. REAL PRIME RATE, MOVED 6 MONTHS FORWARD (DOT)



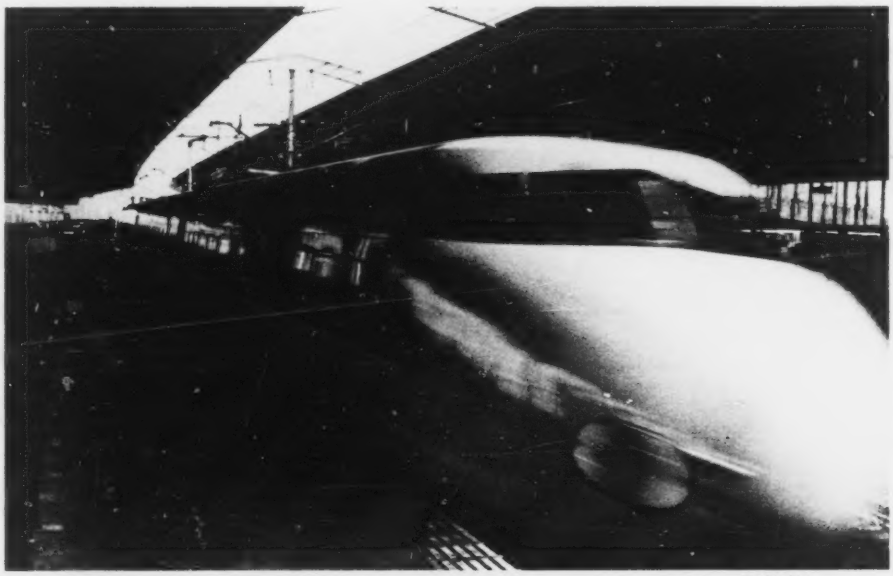
. . . And Interest Rates Will Fall

According to the Commerce Department, the median family income today is about $20,000 per year. The CBO indicates that such a family would see its tax bill reduced by $228 in 1982 under the ERTA. If rescinding the tax cut were to produce a drop of just one percentage point in mortgage rates from today's levels,

that would result in a *per-annum* saving of $483 (assuming a median priced home of $68,000, 25 percent downpayment, 25-year mortgage). In turn, this would enable nearly 23 percent of all households to afford a home, compared with only 15 percent at today's mortgage rates. A drop of four points to around 13 percent — the mortgage rate that most real estate experts feel would be low enough to trigger a revival in homebuilding with its ancillary benefits to the economy — would lower per-annum payments by $1,900 and allow one-third of all households to buy a house!

Needless to say, lower interest rates would also help bring capital spending back to life — thus permitting the Administration to fulfill its goal of revitalizing the U.S. economy. It would also help our trading partners extricate themselves from recession by enabling them to lower their interest rates without risking depreciation of their currencies with its attendant inflationary potential.

At this juncture, time is of the essence. The budget deficit must be reduced as soon as possible in a manner that is credible both statistically as well as politically. In the first instance, the reduction must be large enough to convince the financial markets that Washington's borrowing requirements will be reduced significantly over a sustained period of time. Secondly, this approach must reflect an exercise of political compromise with respect to the sacrosanct: defense, indexed entitlements and revenue restoration must all be part of the package. ■



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The Manufacturers Hanover
Economic Report
Irwin L. Kellner
Senior Vice President and Economist

APRIL 1982

Quarterly Business Conditions Analysis

The old saying that it is always darkest before dawn appears to apply to the state of the U.S. economy. Amid growing talk of gloom and doom, of a seemingly-endless recession punctuated by surprise business failures and the need for the monetary authorities to mount rescue missions, signs of recovery are beginning to appear. To be sure, such a recovery is unlikely to be vigorous or long-lasting like most of its predecessors over the postwar era. Nevertheless, it will mark at least a temporary end to the decline in economic activity that has been underway since summer, 1981.

Before going any further, it should be noted that even this feeble recovery requires that several key assumptions come to pass. These deal with the two elements of economic policy — fiscal and monetary — as well as with political conditions in the Middle East and climatic conditions on the nation's farms. If the assumptions spelled out below do occur, it is reasonable to anticipate expanding economic activity in the U.S. over the balance of the year — albeit at a slow and uneven pace.

Some Early Signs of Recovery...

Since regular readers of this Report can figure out what I think must occur regarding the assumptions referred to above, let me leave them for later, and discuss what might not yet seem apparent — the signs of economic recovery. First and foremost is that in the first quarter of 1982, sales to final consumers after adjusting for inflation rose significantly for the first time in a year. This is important for two reasons: it is a sign that there is a need to buy on the part of purchasers at the consumer, business and government level; and by eating into inventories, it hastens the day when assembly lines will run faster, thus increasing the need for labor, materials and machinery.

That inventories were eaten into is also apparent from the first quarter's GNP accounts. For the first time in a year, the inflation-adjusted level of unsold goods diminished in size. The quarterly decline appears to have been largest on record. Coming in the wake of the steep and prolonged drop in economic activity recorded earlier, this might not necessarily suggest that businessmen have whipped their stocks back into shape. However, it clearly indicates that much progress has been made.

Evidence of at least a modest need to restock comes from the Government's latest report on new orders for durable goods. Led by a 3½ percent jump in orders for nondefense capital goods, total hardgoods orders rose in March for the second straight month. This is the first time since summer 1981 that durable goods orders rose in two consecutive months. And because incoming orders outpaced shipments, durable goods producers reported an increase in their backlog of unfilled orders for the first time in half a year.

For this to carry forward beyond only a few months, it must be accompanied by increased strength in the consumer sector — and it was. While total real final sales were rising less than two percent in the first quarter, real spending by consumers alone jumped by nearly four percent. The increase was broadly distributed and included autos and parts, furniture, clothing, shoes and services.

To make matters even more interesting, consumers have the wherewithal to lift their outlays even further. As I pointed out in the March Report, people in the aggregate are in reasonably good financial shape. Employment levels are high, buying power is growing, use of credit is low compared with people's incomes, and household liquid assets are at record levels. And that's as of the start of the second quarter; comes midyear, incomes will get a lift from two additional sources. The ten percent reduction in personal taxes scheduled for July 1, along with the 7½ percent boost in Social Security benefit payments, will add another $45 billion to after-tax incomes.

Another, even more important fillip to buying power has already arrived in the form of the dramatic slowing of inflation. As recently as third-quarter 1981, consumer

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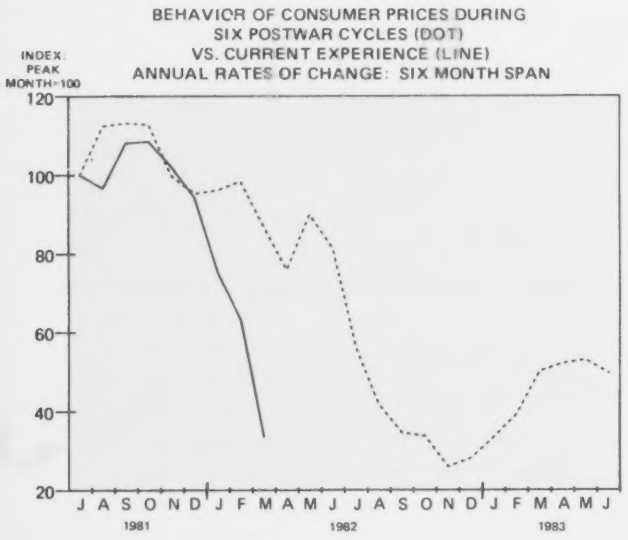
prices were rising at an annual rate of nearly 13 percent. Six months later, in the first quarter of 1982, the pace was down to only a 2½ percent rate of rise—with prices in March registering their first monthly decline in nearly 17 years and their largest month-to-month drop in almost three decades! Since wages continue to reflect earlier agreements, salary schedules and the like, the drop in the rate of inflation during the past half year—not to mention the actual decline in prices in March—has clearly given a substantial, and largely unexpected lift to people's buying power. Translated into the "real world" this means that more and more of us should be noticing a few dollars left over after paying the bills, and if the past is any guide, most of these dollars should find their way into the spending stream before long.

Less inflation will also help the economy at large. It will enable more real growth to be squeezed from the same increase in the money supply than would otherwise be the case. For example, the Federal Reserve believes that its 1982 target for growth in the money supply M1, as much as 5½ percent, is enough to support an increase in nominal GNP of around nine percent. If prices were to go up in 1982 by as much as they did in 1981, nearly nine percent, there would be hardly any room for real growth. But a continuation of the price trends of first-quarter 1982 would allow for more than five percent real growth!



Of course, there is a question as to whether this improvement in inflation will continue—especially if a recovery is, indeed, in the offing. I say it will. For one thing, as the chart shows, inflation tends to stay subdued for several years following the end of a recession. This is because of slack in both the labor force and in industrial capacity, as well as the productivity gains that usually arise during the early stages of recovery. For another, if one were to examine the sources of the slowing in consumer price inflation one would find that there is another reason to think that inflation will remain subdued. Most of the recent deceleration in the consumer price index traces to a decline in the cost of energy, and a stabilization in the cost and financing of housing. While the recessions both here and abroad undoubtedly contributed to the cut in energy usage, hence downward pressures on its price, a good deal also appears to trace to conservation, which is unlikely to change once recovery gets underway. As for housing, it will probably remain depressed as long as mortgage rates remain in the high teens, hence no upward price pressures are in store for this sector.

...But It May Be Feeble...

This brings me to the statement I made at the outset concerning the vigor and longevity of the oncoming recovery. The expansion is more likely to be a repeat performance of the rises in the real GNP that took place in 1979, 1980 and 1981—weak, and of short duration—as opposed to those of earlier years. This is because it will lack both first-stage and second-stage support vital to producing a sharp, sustained economic boom. For one thing, as noted above, the recovery will not get much help from homebuilding. Autos aren't likely to be major contributors either, unless Detroit cuts prices significantly. And exports will remain weak as long as the dollar is overvalued and economies abroad are soft.

Thus the first stage of recovery will have to come from consumer purchases of softgoods, "small-ticket" hardgoods and services—hardly the making of a robust upswing. The second stage will also lack a vital component—business spending. Plant and equipment outlays are unlikely to rise while idle capacity approaches 30 percent and the cost of borrowing money is in the mid to upper teens. What is more, because so many businesses are illiquid, their first use of any increase in incoming cash will be to restore liquidity and pay off some debt, rather than to invest in capital goods.

As you can see, since the recovery will be deprived of its normal sources of strength, it will require every bit of help it can get from adequate supplies of energy and food. Thus it is assumed that both energy and food prices will remain stable compared with other prices. This means, of course, no new war in the Middle East or elsewhere that would threaten oil supplies, and reasonably good growing weather in the farm belt.

Even more important is the need for an agreement between the Administration and the Congress to reduce the Federal budget deficit. This is needed in order to assuage the fears that now exist in the financial markets concerning the government's future borrowing needs in

the context of an unyielding monetary policy and an inadequate supply of savings in the private sector.

...And Could Easily Abort

The extent to which the projected deficit, hence Washington's borrowing requirements, is reduced over the next few years will be a major determinant of the level of interest rates, which, in turn, will have a direct bearing on how fast and how long the recovery lasts. It is generally agreed by both the Administration and the Congress that, left untouched, the deficit would swell to $180 billion in fiscal year 1983, $220 billion in fiscal year 1984, and $240 billion or more in fiscal year 1985. Were this to be the likely course of events, Washington's borrowing needs would soon appropriate all of the net savings that the economy generates and then some, as the table indicates. In anticipation of this lop-sided relationship between the demand for funds and their supply, money-market interest rates would bound upward to new records by midsummer — prolonging and intensifying the first quarter's drop in the real GNP.

FEDERAL AND FEDERAL-RELATED BORROWINGS VS. NET NATIONAL SAVINGS

Year	(1) Federal and Federal-Related Borrowings* ($ billions)	(2) National Net Savings** ($ billions)	Total Federal Borrowings as % of Savings
1960	5.6	29.0	19.3
1970	17.9	70.1	25.5
1980	124.3	169.9	73.2
1981	142.1	192.4	73.9
1982	206.0(3)	223.6(5)	92.1
1983	293.5(4)	259.8(5)	113.0
1984	322.0(4)	301.9(5)	106.7
1985	342.0(4)	350.8(5)	97.5

(1) Fiscal Year

(2) Calendar Year

(3) OMB estimate

(4) OMB/CBO estimate of Federal deficit with no budget compromise, plus off-budget spending of $30 billion, Federally-sponsored agency spending of $30 billion, and guaranteed loans of $42 billion.

(5) Increases 16.2 percent per annum during 1982-85 period, twice the rate of rise posted during the 1971-81 period.

* Federal and Federal-related borrowings are the sum of on- and off-budget (primarily Federal Financing Bank) outlays, borrowing by Federally-sponsored enterprises and Federally-guaranteed loans.

** Net National Savings equals gross private savings (corporate and household), plus state and local government surpluses and capital grants received by U.S. less net foreign investment and capital consumption allowances.

Sources: Treasury Department, Federal Reserve, Office of Management and Budget, Congressional Budget Office, MHT Co.

On the other hand, a compromise that cuts the deficit in half by or before fiscal 1985 would be favorably received by the financial markets. Under this circumstance, short-term interest rates could drop by as much as four points within a few months, then decline another point or two by yearend. Not only would real growth resume immediately, it would pick up steam with each downward movement in interest rates.

For purposes of forecasting, I am assuming neither extreme comes to pass. Rather, I have factored into our model some cuts in the projected deficit — but not as much as the markets would like to see. As a result, interest rates come down — but only slowly. In turn, this allows recovery to get underway before midyear — but at a feeble pace, one that could easily be aborted before yearend.

Never before has politics intruded so much on economics. And never before has an Administration followed such a controversial economic policy as the one it is pursuing today. While almost no one disagrees with the President's basic objectives of slowing the growth in government spending, reducing tax rates to stimulate savings and economic growth, and encouraging the Federal Reserve to conduct a non-inflationary monetary policy, it is the order in which these objectives were implemented that have caused so much concern — especially when projected increases in defense spending are added in. Taxes, hence revenues, have been cut and defense spending has been increased while Congress has yet to decide where to cut nondefense spending. Quoting from the Manufacturers Hanover Economic Report of November, 1980, "... any policy that calls for more spending and less taxes — regardless of what their classroom results might be — will in the real world widen an already swollen budget deficit ... causing either higher interest rates ... or more inflation."

We must consider the realities. While it might be nice to fantasize that the Congress will be forced to cut spending under the threat of huge budget deficits, the facts are that lack of money has not constrained Congress from spending in the past — witness the record. In the past quarter of a century Washington has run a budget surplus only twice — so why should Congress cut spending now, especially in an election year? Yet, all the publicity given the projected deficits is likely to cause Congressmen to think twice before spending any extra money that would flow back into Washington's coffers, were tax revenues to be "enhanced."

The U.S. economy is amazingly resilient. In spite of an unprecedented clash between monetary and fiscal policies which has produced the highest real interest rates in half a century and an equally as high level of business bankruptcies, we are once again poised on the threshold of economic recovery. Whether or not we make it, and for how long is in the hands of a few politicians in Washington. Let us hope they take the right steps — and soon.

April, 1982
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
in $ Billions

	< Actual		Projected >									
	1981		YEAR 1981		1982				YEAR 1982		1983	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2965.0	2998.3	**2925.5**	**11.4**	2995.1	3021.0	3051.2	3095.7	**3040.8**	**3.9**	3129.4	3158.3
GNP: $72	1515.8	1498.4	**1510.3**	**2.0**	1483.6	1479.8	1489.3	1492.2	**1486.2**	**−1.6**	1500.9	1508.4
% Change, Annual Rates	1.4	−4.5	**2.0**		−3.9	−1.0	2.6	0.8	**−1.6**		2.4	2.0
Consumption	1883.9	1908.3	**1857.8**	**11.1**	1950.7	1967.9	1989.3	2003.1	**1977.7**	**6.5**	2031.3	2050.7
Durables	236.2	226.4	**232.0**	**9.5**	236.8	235.7	237.1	236.2	**236.5**	**1.9**	237.9	241.6
Non-Durables	751.3	760.3	**743.2**	**10.0**	766.1	770.1	772.0	767.0	**768.8**	**3.4**	777.5	781.0
Services	896.4	921.5	**882.6**	**12.4**	947.8	962.0	980.1	999.9	**972.4**	**10.2**	1015.9	1028.1
Investment	463.0	443.3	**450.5**	**14.0**	392.6	405.6	415.6	432.4	**411.6**	**−8.6**	433.8	445.6
Non-Residential	335.1	339.8	**328.8**	**11.1**	339.8	322.3	311.7	307.2	**320.3**	**−2.6**	313.0	316.6
Producers Durable Equipment	206.8	205.5	**203.1**	**8.6**	205.7	194.4	190.3	188.2	**194.7**	**−4.2**	195.7	199.9
Structures	128.3	134.3	**125.7**	**15.5**	134.1	127.9	121.4	119.1	**125.6**	**−0.1**	117.3	116.7
Residential	100.5	94.2	**105.5**	**0.3**	92.7	100.1	109.4	118.8	**105.2**	**−0.3**	122.1	125.1
Inventory Changes	27.5	9.4	**16.2**		−40.0	−16.8	−5.6	6.4	**−14.0**		−1.3	3.8
Net Exports	29.3	24.7	**26.0**		23.8	24.7	21.5	21.6	**22.9**		24.1	15.6
Government Purchases	588.9	622.0	**591 2**	**10.6**	628.0	622.8	624.8	638.5	**628.5**	**6.3**	640.2	646.4
Federal Defense	154.1	169.7	**154.3**	**17.2**	171.5	174.5	177.9	183.2	**176.8**	**14.6**	189.9	195.1
Federal Civilian	72.2	83.5	**75.9**	**12.9**	84.1	74.8	71.5	74.2	**76.1**	**0.4**	69.8	68.9
State & Local	362.5	368.7	**361.0**	**7.5**	372.3	373.5	375.4	381.2	**375.6**	**4.0**	380.5	382.5
Final Sales: $72	1500.9	1494.2	**1503.1**	**1.3**	1501.1	1487.4	1491.8	1489.6	**1492.5**	**−0.7**	1501.7	1507.0
% Change, Annual Rates	0.3	−1.8	**1.3**		1.9	−3.6	1.2	−0.6	**−0.7**		3.3	1.4
GNP Price Index (1972 = 100)	195.6	200.1	**193.7**	**9.2**	201.9	204.2	204.9	207.5	**204.6**	**5.6**	208.5	209.4
% Change, Annual Rates	9.9	9.5	**9.2**		3.6	4.6	1.4	5.2	**5.6**		2.0	1.7
PCE Deflator (1972 = 100)	195.7	199.3	**193.8**	**8.3**	201.8	203.3	204.2	206.3	**203.9**	**5.2**	207.7	208.9
% Change, Annual Rates	9.1	7.6	**8.3**		5.1	3.0	1.8	4.2	**5.2**		2.8	2.2
Consumer Price Index (1967 = 100)	276.2	281.4	**272.4**	**10.3**	283.6	285.3	286.8	289.1	**286.2**	**5.1**	291.2	292.9
% Change, Annual Rates	11.8	7.8	**10.3**		3.2	2.4	2.2	3.2	**5.1**		2.9	2.3
Total Personal Income	2441.7	2486.5	**2404.1**	**11.3**	2512.7	2534.7	2537.0	2580.8	**2541.3**	**5.7**	2596.8	2616.4
Disposable Personal Income	2042.0	2088.5	**2016.0**	**10.7**	2115.3	2135.8	2168.9	2202.2	**2155.5**	**6.9**	2210.7	2225.8
Savings Rate	5.2	6.1	**5.3**		5.3	5.4	5.8	6.5	**5.7**		5.5	5.3
Employment Rate	58.9	58.3	**58.8**		57.9	57.6	57.7	57.7	**57.7**		57.9	58.1
Unemployment Rate	7.4	8.4	**7.6**		8.8	9.2	9.3	9.4	**9.2**		9.3	9.2
Indus. Production (1967 = 100)	153.0	146.3	**150.9**	**2.6**	141.4	142.1	143.8	143.6	**142.7**	**−5.4**	145.9	147.2
Housing Starts (000)	961.7	865.3	**1099.8**	**−15.3**	918.7	997.5	1186.5	1316.2	**1104.7**	**0.5**	1257.7	1347.0
Domestic Auto Sales (000)	6933.3	5184.0	**6271.0**	**−4.9**	5966.7	5537.5	6135.7	6131.0	**5942.7**	**−5.2**	6035.0	6253.1
Corporate Pre-Tax Profits	234.4	212.8	**233.3**	**−5.0**	176.2	162.5	178.9	171.1	**172.2**	**−26.2**	175.0	174.1
− Taxes	78.1	68.8	**77.8**	**−5.6**	55.9	51.2	58.7	55.6	**55.3**	**−28.8**	53.8	53.1
Net Profits	156.3	144.0	**155.6**	**−4.7**	120.3	111.3	120.3	115.5	**116.9**	**−24.9**	121.3	121.0
− Dividend Payments	64.8	66.0	**63.1**	**12.7**	66.8	67.2	67.9	68.8	**67.7**	**7.2**	70.0	71.4
Undistributed Profits	91.5	78.0	**92.4**	**−13.7**	53.5	44.2	52.4	46.7	**49.2**	**−46.8**	51.3	49.6
+ Depreciation	187.7	194.9	**183.8**	**16.2**	202.0	211.2	220.5	230.0	**215.9**	**17.4**	237.4	244.3
− Inventory Profits	25.3	22.3	**27.7**	**−39.3**	10.6	4.8	2.2	0.4	**4.5**	**−83.8**	−3.4	−5.1
Net Cash Flow	253.9	250.6	**248.6**	**13.1**	244.9	250.6	270.7	276.2	**260.6**	**4.8**	292.1	299.0

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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Inflation: Down For The Count?

Although prices always go up more slowly during a recession only to rise more rapidly later on, the recent abatement of inflation has nevertheless sparked hopes that the United States economy's protracted bout with continually-rising prices may have taken a turn for the better. For one thing, the slowing of inflation this time has been much more rapid than usual. In the space of less than six months, we have gone from double-digit inflation to an actual price decline—the first time this has happened at the consumer level in nearly 17 years. Even more important, the "real world" is filled with examples of falling prices at all levels of production and distribution—not to mention wage concessions, too. To top it off, financial publications are replete with articles discussing the new environment of disinflation and its impact on business, individuals, and governments.

Coming after more than 30 years of ever-rising prices, these developments are most interesting—if not hopeful. But while it does appear that the behavior of prices has changed somewhat in recent months, it is too soon to let down our guard regarding the need to combat inflation. Indeed, it was just this kind of commentary about how inflation was licked and how the greater problem was getting out of recession in past business cycles that caused the slowing of inflation to be followed by even higher rates of inflation later on. The government would change policies to reflate economic activity, and once the economy showed signs of improving, inflation psychology would reawaken and we would be off and running once again.

Core Inflation Has Declined...

To determine just how much fundamental progress we have made against inflation, it is necessary to look at the three components of it in order to see how each has changed in trend. First and foremost there is the "core" or underlying rate of inflation. This consists of the cost of labor and capital that business incurs and upon which it bases its prices. Of the two, labor costs count for twice as much as capital costs in the typical company. For a variety of reasons, including the way it is raised, capital costs tend to be steadier (and, in recent years, climbing), while labor costs, reflecting compensation and productivity developments, are affected by changes in the pace of economic activity, thus are more volatile. At any rate, it would appear that the core rate of inflation has, indeed, fallen somewhat over the past year and a half—but only to about eight percent, year-over-year. Since this is above the latest 12-month rise in consumer prices, you can see why corporate profits have been squeezed and why business failures are soaring.

It appears that no further significant reduction in core inflation is in sight over the near term. This is because slowdowns in the rate of wage gains (in some cases, actual declines in compensation) are being offset by poor productivity trends as a result of the weak economy. And of course, as long as interest rates remain high and the stock market stays depressed, the cost of raising capital will not come down, either.

...As Has Its Cyclical Component

The second aspect of inflation deals with the business cycle. As you might expect, when economic activity slows business finds it more difficult to raise prices, while labor finds it harder to raise wages. The protracted weakness that has characterized the U.S. economy, not only since summer 1981, but going back to 1979 or earlier in some sectors, has dampened interest in raising prices and wages. From a postwar record annual rise of more than 14 percent set in first-quarter 1980, the rise in consumer prices has slowed to less than seven percent in the most recent twelve months. As I pointed out in last month's Economic Report, the rate of inflation slows, not only during a recession, but for some time afterward as well. This is because of slack in both the labor force and in industrial capacity, as well as because of the productivity gains that usually arise during the early stages of recovery. Thus, on a cyclical basis alone, even assuming that the recent downturn in economic activity has come to a halt, there is every reason to believe that the slowing in inflation will continue for a number of months to come.

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At the moment, because of the prolonged slump in the U.S. economy, both prices and wages appear to be exhibiting a flexibility unprecedented since the 1930s. The regular monthly survey of the National Association of Purchasing Management reveals the highest number of purchasing managers reporting *lower* prices in three decades. On the wage side, there have been numerous instances where workers have "given back" wages, fringes, and working conditions with the intent of helping their employers reduce costs, hence save jobs. Some of these agreements have been in the form of pay cuts, while in other cases workers have been required to produce more at the same pay. In others, wages have been changed from fixed hourly salaries to incentive work where compensation is directly related to output, while benefits have been reduced elsewhere. These concessions have not been confined to blue-collar union members alone, but have spread to white-collar, non-union employees as well. Even more significant, in the case of labor contracts, many of these give-back agreements were renegotiated in mid-contract.

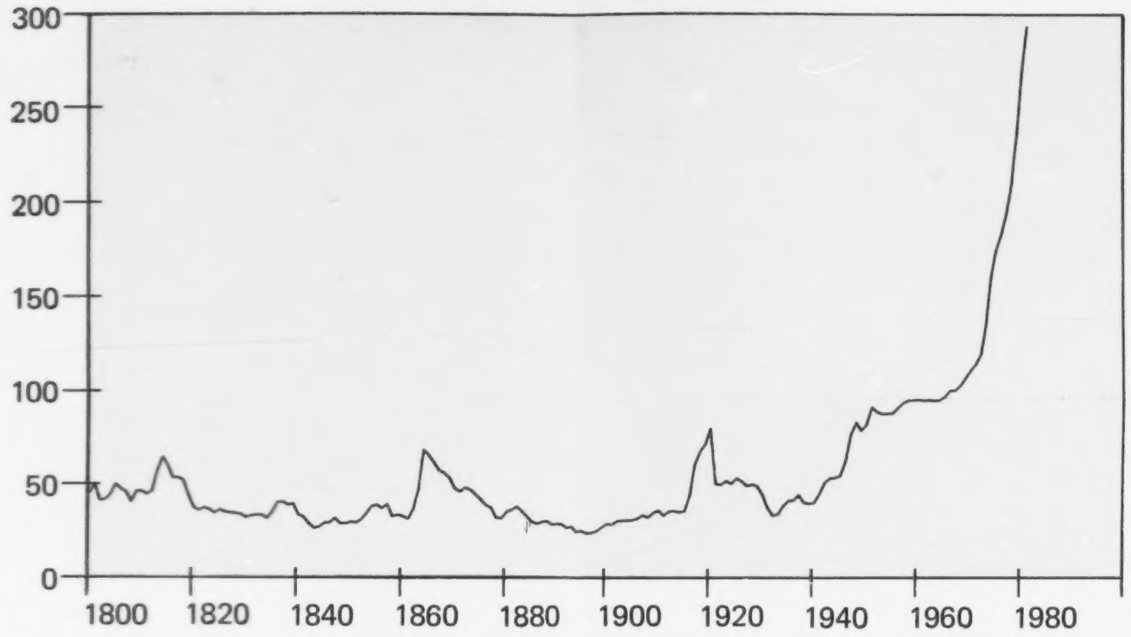
A complete list would be too numerous to mention, but examples include such key industries as automobiles, tires, airlines, steel, meat packing, trucking, and construction. Another aspect of labor costs, strike activity, continues to remain low. At the start of 1982, idleness due to worker walkouts as a percent of estimated available working time was at the lowest rate since World War II.

By its nature, however, the cyclical aspect of inflation cannot be counted upon to provide more than temporary relief. When demand firms up, business tends to abandon price discounting and tries to improve profit margins by boosting prices to the extent markets will allow. For its part, as labor sees employers beginning to earn more money again, it tends to abandon its concessionary stance and asks for increased wages and improvements in working conditions which usually result in higher labor costs. So while the cyclical aspect of inflation is indeed positive for the moment, and will continue so for some time to come, it cannot be counted upon to produce a permanently lower rate of inflation all by itself.

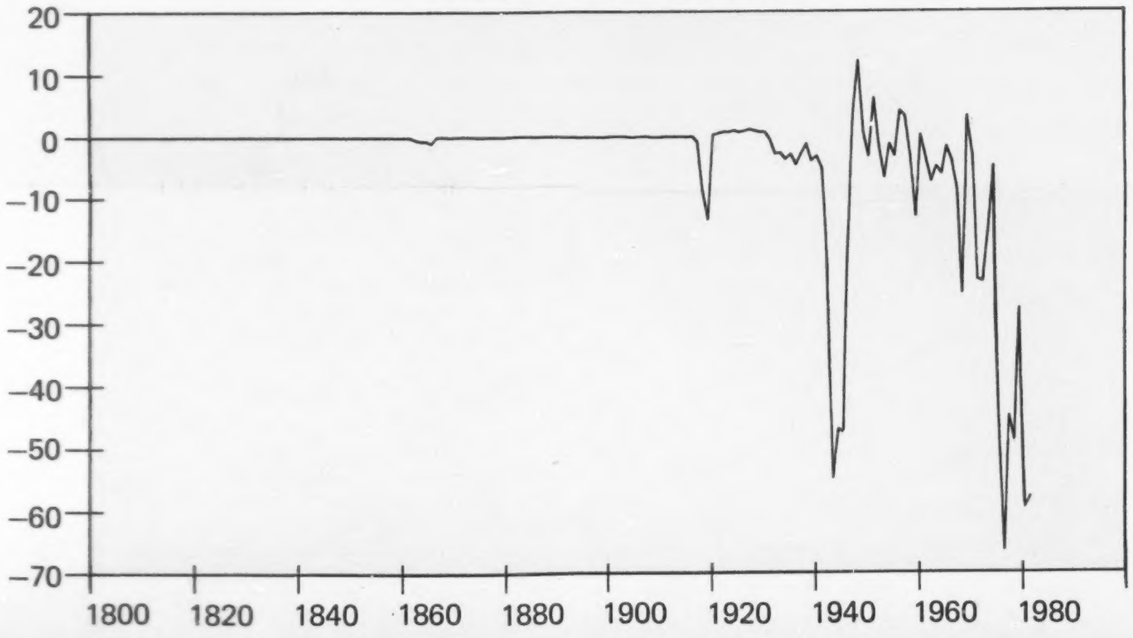
Some Shocks May Not Reappear...

The third component of inflation has been around as long as the price statistics have been assembled. It deals with shocks—sudden and unanticipated boosts to the price level which originate outside the normal trend in economic activity. They include, obviously, anything that has an abrupt effect on either demand or supply. I suppose that unusual weather represented the first shock that people had to contend with since it affected supplies of foods. Wars also constitute a shock as do such other government-administered developments as the imposition and lifting of wage and price controls. Sudden changes in the foreign exchange

PRODUCER PRICE INDEX, 1800–1981
ALL COMMODITIES, 1967=100



FEDERAL GOVERNMENT SURPLUS OR DEFICIT, 1800–1981
BILLIONS OF DOLLARS



value of currencies, abrupt changes in fiscal and monetary policies—and, since 1973, sudden changes in the price and availability of fuels constitute shocks as well.

To the extent that these can be anticipated (and, literally by definition, they are difficult to foresee), it would appear that shocks are unlikely to be an additive factor to inflation over the near term. Foodstuffs seem plentiful, while the same may be said for oil, suggesting that, at worst, prices of these two important commodities will be stable over the near term. The advent of floating exchange rates has reduced the probability of sudden shocks from foreign exchange, although the dollar has swung widely in recent years. Of course, the volatile situation in the Middle East and the South Atlantic should serve as constant reminders that the threat of war is ever-present.

Another shock element deals with government policies regarding controls. We saw how the after-effects of wage-price controls of the early 1970s and the credit controls of spring 1980 affected people, prices and markets. One would hope that controls will not be resorted to again in an effort to dampen price pressures but this will depend, not only on economic considerations but on politics as well—and you know how unpredictable politicians can be.

...But Others Are Still Around...

In the final analysis, the battle to lower inflation permanently will depend mainly on how the government runs its economic policy. In turn, this aspect will depend on the ability of the anti-inflation forces to generate and maintain a constituency. For as I noted earlier, just when it appeared that inflation had been licked in previous business cycles, the costs in terms of unemployment, the inability of business to adjust, etc. weakened the anti-inflation forces and encouraged the government to reflate.

Interestingly, as you can see from the top chart, inflation, for all its seeming longevity, is not a way of life for the U.S. There was virtually no inflation, point to point, between 1800 and the early 1940s. And even as recently as twenty years ago, producer prices were only twice their levels of the early 19th century. Since then, the trend has virtually been straight up. Notwithstanding the components I analyzed earlier, it would seem to me that the basic, underlying cause of inflation can be seen from the lower chart, and that is fiscal policy.

It is more than coincidental that the price spiral began when Washington started to run frequent and growing deficits in its budget. And while deficits, themselves, need not be inflationary, they turned out that way because the Federal Reserve replaced the money that Washington borrowed in the financial markets in order that there be some funds left for the private sector. As you know, this resulted in an expansion of the supply of

money and credit at a faster rate than the economy could absorb. In turn, this increased demand at a faster rate than supply — the basic definition of inflation.

What makes me reluctant to relax the vigil against inflation at this time is what seems to be the likely trend of government policy. We are at a point now where the three major components of inflation — shock, cyclical, and core — are either stable or heading downward. Inflation psychology is changing, witness price discounting by business and wage and benefit concessions by labor. But financial market participants remain wary, and are keeping interest rates high because of what they believe is coming in economic policy.

To be sure, few would question the Federal Reserve's current monetary posture or its intent to remain tight under "ordinary" circumstances. Indeed, it is the slowing of the growth in the money supply over the past several years that has been the major factor in the reduction of inflation. However, in the context of continuous budget deficits, this slowing in money growth has also made money less available and more expensive to the private sector, thereby contributing to recession as well (and, in the current instance, to half-century high rates of business failures). The markets are concerned that, in the absence of a significant reduction in the government's projected budget deficit, the Federal Reserve will have to yield in order to stave off a severe slump in economic activity — and in the process, will set off a new round of inflation.

...So We Can't Relax Just Yet

In actuality, reducing Washington's budget deficit is not all that will have to be done in order to further unwind inflation on a sustained basis. If business is to earn a decent rate of return, the core rate of inflation must be reduced as well. Bearing in mind that the major component of core inflation is labor costs, and that these, in turn, are determined by the interaction of compensation and productivity trends, it would appear that policies that would enhance capital formation and capital investment thus boosting productivity and lowering the cost of capital would go a long way toward reducing core, or underlying inflation.

In this regard, the Reagan Administration has made a good start, with its emphasis on the supply side. Unfortunately, the program as actually enacted went further than enhancing capital formation and providing incentives for business to invest. Although the personal tax cut was indeed structured so as to provide an increase in savings, the pool of savings does not seem to be expanding enough to make up for the loss in revenues that the Administration, itself, believes will occur because of the tax cut and the huge increases projected for defense spending. When combined with the high rates of interest generated by financial markets' fears regarding future trends in the overall demand for funds compared with their supply, this program has forced business to trim its investment plans thus frustrating its supply side aspects.

At this point, it would appear that a midcourse correction is in order. For the first time since our protracted bout with inflation began, we have an opportunity to unwind the ever rising price spiral. It depends — not just on the availability of food and fuels, and not on the willingness of business and labor to price products and services realistically. Rather, it depends on a few politicians in Washington and their willingness to make the hard choices necessary to keep inflation down for the count. H

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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The Fed's Dilemma

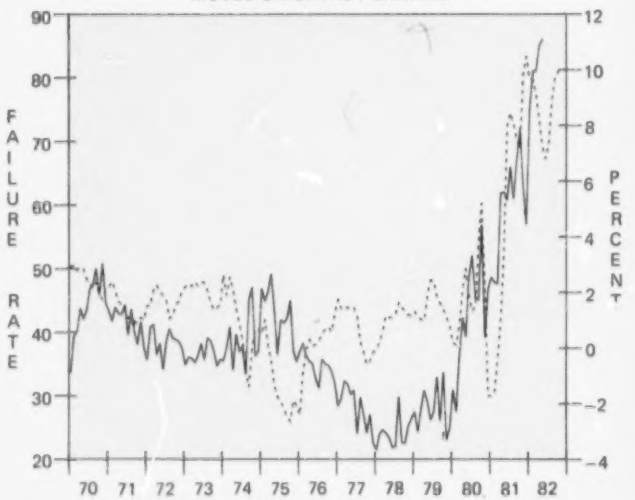
Unable to draw up a plan for spending and taxes that would convince the financial markets that they have control over the budget process thus enabling interest rates to decline, some elected officials in both the Administration and the Congress have turned their attention to the Federal Reserve. The Reagan Administration is reportedly considering proposals that would restrict the independence of the Fed. For its part, the Joint Economic Committee recently held hearings discussing the conduct of monetary policy with the intent of determining what could be done to bring interest rates down fairly quickly in order that the economy might recover from its prolonged slump. Not surprisingly, the Federal Reserve was widely criticized for its performance. While the Fed is no stranger to criticism, it seems to be more intense than usual.

The critics divide into two camps. Those who follow the so-called monetarist view complain that the Federal Reserve has once again strayed from the path of righteousness. They believe that the Fed's credibility as a devoted inflation fighter is in question because the money supply has grown faster than this year's maximum target. On the other hand, the central bank is being criticized with equal vigor by many elected officials in the Congress, a few in the Administration, some nonmonetarist economists—not to mention a growing chorus of businessmen--for being too restrictive with money growth. About the only thing that everyone agrees on is that interest rates are too high (see Chart I) and that, somehow or other, the Federal Reserve can do something about it.

To Bring Interest Rates Down ...

The Federal Reserve's dilemma is that it can't—at least not without some fancy footwork. Thanks to the rise of monetarism and its influence on the financial markets, the Fed can no longer control interest rates the way it used to. To be sure, the Fed could push short-term rates down by purchasing government securities in the hands of banks and dealers thereby injecting liquidity into the economy. But this would be a short-lived solution if it were to produce growth in the money supply faster than that called for by the Fed's target range. Ultimately, the markets would bid up interest rates, reflecting either the anticipation of future tightening by the Fed, or the inflationary consequences of too much money growth.

CHART I
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE) VS. REAL PRIME RATE, MOVED 6 MONTHS FORWARD



On the other hand, if the Fed were to strive vigorously to bring the money supply into its target range, it would run the risk of exacerbating an already precarious economic situation. There is no doubt that business liquidity is drying up at an alarming rate. Corporate balance sheets are weaker than at any time in postwar history —thanks in good part to the sudden disappearance of inflation. Unable to adjust to zero inflation after years of steadily rising prices, most businessmen find that they are still geared for an inflationary environment. This means that their costs—including the cost of money—are rising faster than selling prices. Lower interest rates would help business make the transition to a less inflationary environment; right now this does not seem to be in the cards. In the meantime, deteriorating financial conditions appear to be claiming larger and larger victims. Tightening monetary policy in order to slow money growth would only worsen this trend and raise serious questions as to the viability of large segments of the private sector.

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As I see it, there are two problems here which need to be solved. The first is to bring interest rates down, while the second is to convince the markets that the first will not be accomplished at the expense of fighting inflation. There are several ways in which interest rates can be reduced consistent with maintaining an anti-inflation posture. First and foremost is the need for an agreement between the Administration and the Congress to reduce the Federal budget deficit for fiscal year 1983 and beyond. Only after the financial markets see a series of credible deficit figures showing a declining trend will their fears concerning the government's future borrowing needs be assuaged—permitting interest rates at all maturities to fall closer to normal levels relative to inflation.

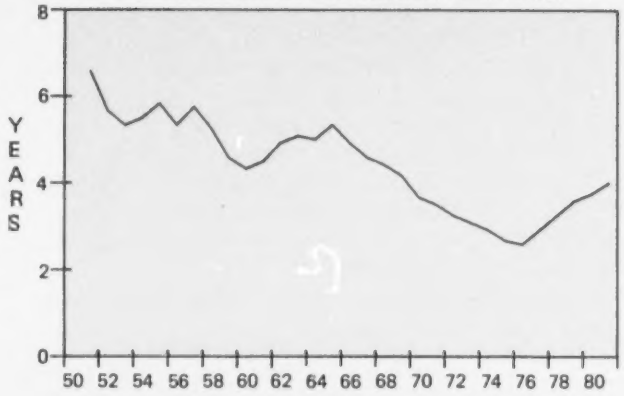
Not long ago several steps were taken in this direction by the two houses of Congress resulting in a projected budget deficit for 1983 of a little over $100 billion. However, many in the financial markets are skeptical that the Congress will be able to adhere to even this record number. The economic assumptions have been called unrealistically optimistic. Spending levels have been assailed as understated, while revenue expectations have been termed overestimated. In addition, there are concerns that the inevitable political pressures will cause even more spending and less revenues, once the various constituencies see how their programs have been impacted. Furthermore, there remain the budgets for 1984 and 1985—which require even deeper slashes in spending and/or greater revenue "enhancements" in order to drive the deficit down further. What I am saying, in other words, is that this process, as fundamental as it is, may take a while before it produces the results that the financial markets want to see. Yet, time is of the essence, so we must examine the other possible ways to bring interest rates down.

. . . The Treasury Should Sell Bonds . . .

Because it is such a major factor in the financial markets, the Treasury affects interest rates by virtue of the volume of securities offered to the markets, as well as the maturity areas in which it borrows. Although it has long been the intent of the government's debt managers to lengthen the maturity of Washington's debt—that is, sell securities with the longest possible maturity dates—for a variety of reasons they have not, with the result that the average maturity of the Federal government's debt has fallen to only four years (see Chart II). Plainly, this means that Washington must borrow incessantly, not only to finance current needs, but to pay off earlier obligations as well. This huge (and obviously growing) demand for short-term funds by Washington is a key reason for short-term interest rates being as high as they are today.

It would thus seem logical that Washington should consider selling securities of long-term duration. To be sure, this means that Washington will be locking in

CHART II
AVERAGE MATURITY OF TREASURY SECURITIES



costly, non-callable long-term funds. But it could have salutary side effects by reducing demands for short-term credit. This alone might depress short-term interest rates to a level well below rates in longer maturities. Such a positively-sloped yield curve would confront investors with a substantial penalty for committing their funds to short-term money market instruments as opposed to longer-term securities. If this penalty were enough to offset current fears of future inflation, as well as of the likely course of fiscal and monetary policy, a substantial portion of investors would once again lengthen the maturity structure of their assets. As more cash flows into longer-term instruments, interest rates would begin to drop, opening up an opportunity for business to access the longer debt markets. To the extent that business can borrow in the longer-term markets these days, it will use these funds mostly to pay off short-term debt—in the process keeping the yield curve positively sloped.

The process of "twisting" the yield curve to a positive slope would be helped if the Federal Reserve were to pump a little more liquidity into the economy. The Fed has done this before, the most recent instance being autumn, 1981. At that time, however, the money supply was growing *below* the 1981 target ranges, so the markets were not unduly upset when they saw the Fed injecting additional reserves into the banking system with the intent of speeding up money growth. Indeed, interest rates fell as the money supply grew more rapidly, reflecting, for once, the usual liquidity effect: i.e., more money in circulation depresses its price. However, the Fed does not have that luxury today, since, as you can see from Chart III, the money supply is growing *above* its target path. Unless the Federal Reserve can convince the markets that faster money growth does not mean abandoning the fight against inflation, any contribution it might make toward twisting the yield curve positively would backfire.

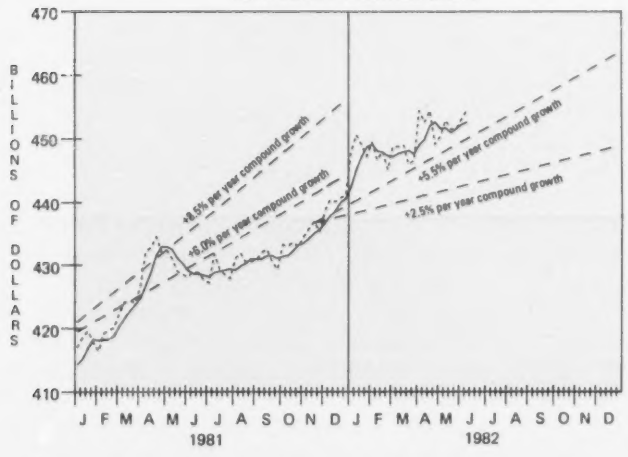
. . . While the Fed Eases a Touch

In my view, the Fed can justify adapting a somewhat easier money posture. One way to accomplish this might be to remind the markets that, however worth-

while it might be to aim at a low enough rate of money growth consistent with fighting inflation, such a process need not be followed week in and week out. Most economists would agree that transitory fluctuations in the money stock cause little or no problems in and of themselves, provided that they are offset within a reasonable period of time. As Paul Volcker, Chairman of the Federal Reserve Board, recently said in Congressional testimony, "We need also to be conscious of the fact that the world as it is requires elements of judgment, interpretation and flexibility in judging developments in money and credit and in setting appropriate targets."

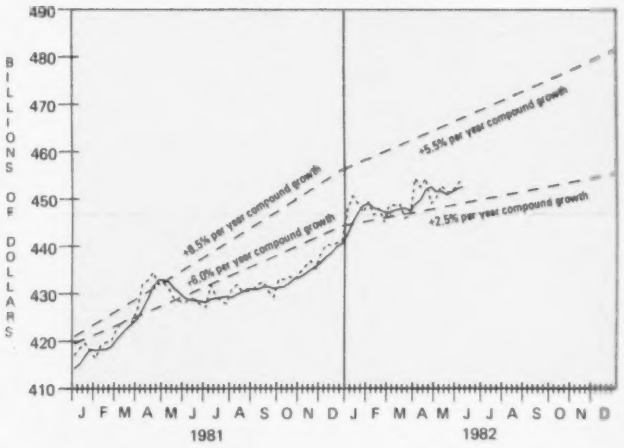
Critics of this proposal would argue that all they have seen in recent months have been "transitory" fluctuations and that they are unsure at any one time as to whether the Fed is either able or willing to keep money growth under control. To this I would point out that over longer spans of time the growth of money has been restrained. From fourth-quarter 1979 through first-quarter 1982, the money supply M-1 grew at a 6.6 percent annual rate—down from the 8.1 percent dip of the previous ten quarters. Quoting Paul Volcker again, "This longer-run and broader perspective is what should be kept in mind when considering growth in the aggregates." He went on to say that the Board's decision to publish the money supply data in the form of four-week moving averages is designed to divert attention from the statistical noise inherent in the weekly figures and to encourage people to focus on the broader trends.

CHART III
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



I think this is a good idea, but would go one step further. In my opinion, monetary policy cannot simply focus on one aspect of the economy—the rate of inflation. It must also focus on the "real" world. And while inflation has been subdued, many companies are going down for the third time, thus need help quickly in the form of lower interest rates and greater availability of money. The Fed could provide this without unduly alarming the financial markets. All it need do is reposition its growth targets for 1982 as suggested in Chart IV. As you can see, the lower band still slopes upward at 2½ percent compound growth per year while the upper rises at 5½ percent per year. In this regard, the targets are unchanged. What is different, obviously, is the fact that they don't begin from the *average* of the money supply in the fourth quarter of 1981. Rather, they begin as an *extension* of the target bands for the year 1981.

CHART IV
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE)
VS. WEEKLY FIGURES (DOT)



I can offer two lines of defense for reconstructing the 1982 targets. For one thing, there is no hard and fast rule that I know of that says that the point of a year's money growth targets must begin with the average for the fourth quarter of the previous year. Because the money supply undershot its 1981 targets but was rising toward yearend, it stood to reason that, no matter what the weekly wiggles were, the money supply would start out the new year above target—which, indeed, it did (see Chart III). Had the money supply accelerated back in August or September of 1981—then flattened to its January-February 1982 levels—the 1982 growth targets would be in approximately the position I have shown.

Business Needs More Liquidity

Of course, for all this to be accepted by the markets, the Fed should point out that this is not being done in the context of accelerating inflation. Rather, this change would be made in an era of little or no inflation. Referring to the growth in the money supply over a longer span of time, Chairman Volcker said "The restrained growth has, in my judgment, contributed importantly to the now clear progress toward reducing inflation." In other words—this adjustment would be undertaken not to validate inflation, but rather, to provide a little liquidity for the real economy to revive.

While this adjustment is suggested to assuage the fears of those in the financial markets who place great faith in monetarism, it should be pointed out that this is

not intended to suggest that monetarism must be followed blindly week in and week out. Furthermore, to the extent it is useful at all, monetarism will produce optimal results only when monetary and fiscal policies are in harmony—and not at opposites as has been—and is still—the case.

The evidence of the past few years makes it clear that tight money can indeed bring down the rate of inflation—but only at the expense of subduing the real economy as well when fiscal policy requires the Federal government to increase its borrowings in the financial markets. To be sure, there will always be some pain associated with slowing inflation. However, the pain we are suffering is the worst since the 1930s and must be alleviated before it leads to a repetition of the 1930s. And I cannot stress too strongly that time is important: The economy cannot take too many more months of interest rates at these levels. M

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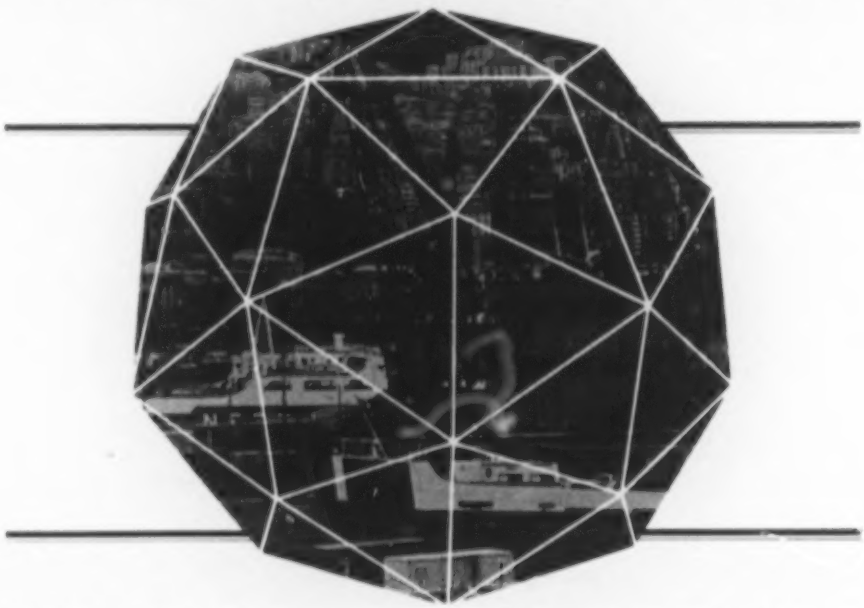

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JULY 1982

Business Conditions Update

If this is an economic recovery, it would be very interesting to see what a recession is like. While the overall economy did expand somewhat during the second quarter as had been widely anticipated, the increase was more statistical than real. Except for a few isolated industries and even fewer regions in the country, there does not seem to be many signs from the real world that activity is picking up. To be sure, this, too, was expected; few economists outside those in the Administration expected the upturn to be anything but mild. But the gloom and doom that pervades the land during what is supposedly the second calendar quarter of an economic upswing would seem to belie even the cautious views of most private-sector economists.

It is important to examine these views in assessing the current economic scene. This is because those indicators that economists normally look at in an effort to divine the future are giving off mixed signals—as they have been for quite some time. Some key statistics are pointing up while others are pointing down. Furthermore, revisions of previously-released data tend to confuse comparisons.

The Statistics Are Mixed

For example, take the overall gross national product. Although the Commerce Department's initial estimate for the GNP adjusted for inflation in the second calendar quarter put the economy's growth at an annual rate of 1.7 percent, other reports issued at about the same time suggest that the economy continued to contract. Industrial production declined in June for the tenth month in the past 11, housing starts fell 15 percent following a one-month increase, and new orders for durable goods fell 1.6 percent (5½ percent for nondefense capital goods). To make matters even worse, there was a sharp drop in retail sales in June following increases during April and May.

If this is not confusing enough, July is the month in which the government revises its figures on the gross national product going back for several years. By definition, revisions result in numbers either becoming higher or lower than earlier estimates. This time, however, most of the revisions were downward—especially for the period beginning in autumn, 1981. Whereas the Commerce Department earlier thought that fourth-quarter 1981's real GNP fell by an annual rate of 4.5 percent compared with the third, it now thinks that the rate of descent was 5.3 percent. Furthermore, first-quarter 1982's real GNP is now believed to be down at a 5.1 percent pace compared with the 3.7 percent clip previously reported. The net result is that the level that the government estimates for second-quarter 1982's GNP—$1,477 billion—while 1.7 percent higher than the revised first quarter, is actually lower than the government's earlier estimates for the first quarter by an annual rate of two percent!

Another factor contributing to the second quarter's "rise" in the GNP was the government's treatment inventories. The way the GNP is put together, an increase in the rate of stockbuilding adds to it while a reduction in the level of inventories is a subtraction. In the first quarter, inventories adjusted for inflation were reduced by $15½ billion at annual rates. In the second quarter they were reduced also—but only by a $7 billion pace. This moderation in selling from inventories translated into an $8½ billion "addition" to the GNP between the first and the second quarters—hardly the beginning of an economic recovery.

Looking at data for the first few weeks of the third quarter suggests that the weakening in June has continued. Most key statistics describing the production of goods and energy, transportation, business activity and employment levels worsened during the month of July. Of course, since July is a month when many plants close for vacation, this comparison is being made after taking normal seasonal developments into account.

NO REPORT IN AUGUST

The monthly Economic Report will not be published during August. The next issue will appear in September.

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In the minds of consumers and businessmen, the economy may still be heading south. To be sure, business sentiment is not considered a leading—or even a coincident—economic indicator. Businessmen tend to see changes in economic trends long after they have taken place. But for attitudes to worsen as the economy turns up is most unusual. Furthermore, consumer attitudes tend to be more in tune with the pace of the economy (not surprising, since consumer spending accounts for two thirds of the GNP) and public confidence is none too good at the present time.

Why Attitudes Are Gloomy

A lot of reasons could be advanced for these sour attitudes. Disillusionment with Reaganomics is an obvious choice; concern over high interest rates is no doubt a factor, too. Of course, there is nothing wrong with business attitudes that a few more orders could not cure. However, these increased orders are unlikely to occur in the present environment. Because of weakness in exports, residential construction and domestic automobile sales, it is not surprising that businessmen's inclination to invest in capital goods is much reduced. It may be true that plant and equipment spending typically lags an upturn in overall economic activity, but at the moment it is dragging things down. Most businesses, it seems, are cutting back planned projects, either by stretching them out, or by canceling them altogether.

What is significant is that this back-pedaling on capital investment has occurred despite incentives provided by the Administration since early last year. "Real" nonresidential fixed investment as measured in the GNP accounts has declined for six months now, dropping at a seasonally adjusted annual rate of 8.5 percent in second-quarter 1982. Companies have been struggling with a downturn in sales, excess inventories and the high cost of borrowing. By cutting production some ten percent since last July, businessmen have idled more than 30 percent of capacity in the nation's factories, all but eliminating the need for expansion.

Ironically, one development that would ordinarily be cheered has caused some people's moods to sour. This is the sudden and dramatic slowing of inflation. It would seem that most people do not think that the rate of inflation is any slower today than it was a year ago —at least according to some surveys. But inflation has slowed—notwithstanding the monthly increases of one percent each in May and in June at the consumer level. For at the wholesale or business level, inflation has all but disappeared as producer prices rose at a 2½ percent annual rate over the first six months of this year compared with a 10 percent pace in the first six months of 1981.

Going further back to the basic commodity level, one finds not inflation, but deflation. Commodities prices have been falling for the better part of the past two years. Such key commodities as copper, aluminum, paperboard and scrap steel, have posted lows not seen in recent memory. An overall index of industrial raw materials' prices formerly produced by the Bureau of Labor Statistics and now carried on by the Commodity Research Bureau shows that sensitive industrial materials' prices in the aggregate are no higher today than they were in 1974.

This deflation—or, at the very least, disinflation—has hit business management like a ten-ton truck. It seems that inflation had helped management in many ways, and its absence is apparently hurting. Quoting from the Manufacturers Hanover Economic Report of June, 1981: "Inflation allows businessmen to raise their prices without losing customers, since people are more likely to accept higher prices in an inflationary environment than when prices are stable. Naturally, inflation will boost the dollar value of sales and earnings thus making many a manager look good—at least on the surface ... Many businessmen look to inflation as a cushion, in that they can pass along increases in costs more readily in an inflationary environment than in an era of price stability." (That Economic Report, by the way, suggested that there were many other groups in the country besides businessmen who have learned to live with inflation—if not depend on it. These groups are obviously hurting because of inflation's slowing yet dare not suggest that policymakers pump up the price level once again since price stability is a "motherhood and apple pie" issue. Not surprisingly, such mixed emotions have also confused and depressed people.

Where Will The Strength Come From?

Considering these attitudes and their sources, it is nothing short of amazing that there are forecasters who believe that a strong upturn is highly likely in the second half of 1982. Some of these forecasters work for the government, so their optimism should not be surprising. However, others are in the private sector, where, presumably, a more objective view can be taken. Let us therefore examine their arguments to see just how credible they are.

Those who have a simple model dealing with the money supply and its relationship to economic activity are looking for a pickup in second-half 1982. They point to the growth that the Federal Reserve says it will allow in the monetary aggregates and add to it the increase in velocity (turnover of money) that usually occurs at this point in a business recovery. However, they fail to take into account the fact that the demand for money continues to overwhelm the supply—even with increased velocity. For one thing, most borrowing by the private sector is being concentrated in the short-term markets where money first surfaces. Because of an inability or an unwillingness to access the

long-term markets, business is forced to concentrate its fund raising in the short-term markets. This means, of course, that the volume of borrowing is enlarged because of the shortness of the duration of the loans.

Then there is Washington and its associated credit needs. Net new Treasury cash requirements are likely to exceed $100 billion in the second half of this year alone, well above the $60 billion raised during the comparable 1981 period. In the first three weeks of July, net Treasury borrowings surpassed $17 billion—$5½ billion more than the net amount raised in all of second-quarter 1982!

Under these circumstances, an economic recovery could cause further imbalances between the demand for money and its supply. Normally, business loan demand drops in the later stages of a recession and the early months of an economic recovery as lower interest rates, augmented by improved cash flow, permit business to reduce its short-term debt. But interest rates are still high and the economy remains weak. As a result, short-term debt continues to grow, while cash flow continues to decline.

The dramatic slowing of inflation will delay any improvement in cash flow. This is because it will prevent business from raising prices at the first sign of firmer markets. Government borrowing usually is not reduced in the early stages of an economic recovery since tax revenues are affected only with a lag. For their part, household borrowings might rise if consumers were to expand their purchases of anything but small-ticket items. Thus it would seem that the money supply argument is not convincing, insofar as it being a reason to expect a recovery in economic activity.

What about the consumer, especially since people have just gotten a boost in their after-tax income from the ten percent cut in tax rates and the 7½ percent rise in Social Security Benefits? Well for one thing, the amounts involved are so small that they are unlikely to be spent immediately. No family's take-home pay was increased by more than $13.40 a week; for most it was considerably less—while for the average family it was $4.38! Show me the person who goes out and makes a major purchase based on these sums and I will show you an optimist.

Besides its small size, this tax cut is being overwhelmed by increases in taxes, fees and public utility rates at the state and local level. Those macroeconomic models that only factor in the cut in Federal tax rates in calculating changes in disposable personal incomes and ignore what is going on at the state and local level will produce results at variance with reality.

If the consumer does not come through and lift his outlays dramatically starting this quarter, then business inventories may not be in as good shape as some think. True, the inflation-adjusted level of business inventories was reduced by an annual rate of $11 billion in first-half 1982. But this only offset the $11 billion rise in real inventories that occurred in second-half 1981. Meanwhile, real final sales at midyear 1982 were $6½ billion lower than they were a year earlier. This left the ratio of inventories to sales adjusted for inflation at 1.8 months' sales, compared with 1.7 one year earlier—hardly an indication that stocks are low enough relative to sales to encourage increased rates of production.

Even if the consumer does increase his spending somewhat over the coming months, the type of goods that he is likely to buy will not contribute much to the economic recovery. This is because high interest rates and reduced confidence will cause people to concentrate on such "small-ticket" items as video games, personal radios, clothing and so forth. Besides the fact that a lot of these goods are made overseas, those that are produced here are so small that they take a long time before they translate into a need on the part of business to increase production lines to the point where capital spending pressures develop.

Conclusion

Putting it all together, I find it difficult to come up with enough sources of strength to push the economy ahead by more than a snail's pace over the next few calendar quarters. This would be in distinct contrast with previous economic recoveries, where the GNP in real terms would be climbing at a ten percent annual rate or greater early in an economic recovery. The slow pace of the ongoing rebound makes it susceptible to any unusual development that could strike the economy such as bad weather here or abroad, a sudden change in oil prices and/or supplies or another bout of monetary instability which could cause the money supply to jump upward and the markets to boost interest rates in anticipation of a tightening by the Fed to pull the money aggregates back down.

Needless to say, politics, already very much an influence on economic activity, could impact the recovery even further. Congress continues to find it difficult to cut spending and increase revenues enough to reduce the budget deficit. For its part, the Administration refuses to budge on its tax cut program, or on defense spending. These political developments do not generate confidence among financial market participants that the government's financing needs can be reduced. Unless the public sector reduces its needs for funds, the private sector cannot expand its borrowings while the Federal Reserve remains committed to a tight money policy. We must have a political compromise in order for the economy to strengthen—and the sooner, the better. H

July, 1982

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< Actual				Projected >							
	1981		YEAR 1981		1982				YEAR 1982		1983	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2980.9	3003.2	**2937.7**	**11.6**	2995.5	3047.4	3115.2	3163.3	**3080.4**	**4.9**	3221.4	3292.6
GNP: $72	1510.4	1490.1	**1502.6**	**1.9**	1470.7	1476.8	1484.4	1485.7	**1479.4**	**−1.5**	1493.0	1503.7
% Change, Annual Rates	2.2	−5.3	**1.9**		−5.1	1.7	2.1	0.4	**−1.5**		2.0	2.9
Consumption	1868.8	1884.5	**1843.1**	**10.6**	1919.4	1950.8	2003.6	2039.5	**1978.3**	**7.3**	2082.8	2114.4
Durables	241.2	229.6	**234.5**	**9.4**	237.9	242.6	253.1	255.0	**247.1**	**5.4**	264.0	264.3
Non-Durables	741.3	746.5	**734.5**	**9.6**	749.1	756.5	777.2	789.4	**768.1**	**4.6**	803.0	812.2
Services	886.3	908.3	**874.1**	**11.7**	932.4	951.6	973.2	995.1	**963.1**	**10.2**	1015.8	1038.0
Investment	486.0	468.9	**471.5**	**17.2**	414.8	429.1	436.2	434.0	**428.5**	**−9.1**	447.1	476.6
Non-Residential	353.0	360.2	**346.1**	**12.0**	357.0	354.0	341.6	329.6	**345.6**	**−0.2**	337.2	347.8
Producers Durable Equipment	220.2	220.6	**216.4**	**8.9**	215.6	210.8	203.1	197.7	**206.8**	**−4.4**	205.6	214.4
Structures	132.7	139.6	**129.7**	**17.4**	141.4	143.2	138.5	131.9	**138.8**	**7.0**	131.6	133.4
Residential	101.2	95.5	**105.0**	**1.7**	93.4	94.7	104.6	109.1	**100.5**	**−4.3**	112.9	124.9
Inventory Changes	31.8	13.2	**20.4**		−35.6	−19.7	−10.0	−4.7	**−17.5**		−3.0	3.8
Net Exports	25.9	23.5	**26.1**		31.3	35.6	34.6	34.9	**34.1**		27.1	27.4
Government Purchases	600.2	626.3	**597.0**	**10.9**	630.1	631.9	640.8	655.0	**639.5**	**7.1**	664.4	674.2
Federal Defense	154.4	166.9	**153.7**	**17.0**	166.2	172.2	176.7	183.2	**174.6**	**13.6**	190.1	194.9
Federal Civilian	75.7	83.6	**75.2**	**14.3**	83.5	71.9	71.0	73.2	**74.9**	**−0.4**	74.1	73.9
State & Local	370.1	375.7	**368.0**	**7.8**	380.4	387.8	393.1	398.6	**390.0**	**6.0**	400.2	405.4
Final Sales: $72	1493.9	1485.3	**1493.7**	**1.0**	1486.1	1483.7	1489.0	1487.8	**1486.7**	**−0.5**	1494.3	1502.2
% Change, Annual Rates	1.0	−2.3	**1.0**		0.2	−0.6	1.4	−0.3	**−0.5**		1.7	2.1
GNP Price Index (1972 = 100)	197.4	201.6	**195.5**	**9.4**	203.7	206.4	209.9	212.9	**208.2**	**6.5**	215.8	219.0
% Change, Annual Rates	9.0	8.8	**9.4**		4.3	5.3	7.0	5.9	**6.5**		5.4	6.1
PCE Deflator (1972 = 100)	196.4	199.8	**194.5**	**8.6**	202.2	204.0	207.4	210.3	**206.0**	**5.9**	213.5	216.6
% Change, Annual Rates	8.1	7.1	**8.6**		4.9	3.6	6.9	5.7	**5.9**		6.3	5.9
Consumer Price Index (1967 = 100)	276.2	281.4	**272.4**	**10.3**	283.6	286.8	293.0	297.2	**290.1**	**6.5**	302.0	306.4
% Change, Annual Rates	11.8	7.8	**10.3**		3.2	4.6	9.0	5.8	**6.5**		6.7	6.0
Total Personal Income	2458.0	2494.6	**2415.8**	**11.8**	2510.4	2549.5	2614.5	2654.3	**2582.2**	**6.9**	2702.9	2758.0
Disposable Personal Income	2060.0	2101.4	**2029.1**	**11.2**	2117.1	2151.9	2236.7	2267.3	**2193.3**	**8.1**	2303.2	2340.1
Savings Rate	6.5	7.5	**6.4**		6.6	6.6	7.7	7.3	**7.0**		6.8	6.8
Employment Rate	58.9	58.3	**58.8**		57.9	57.8	57.9	58.1	**57.9**		58.2	58.3
Unemployment Rate	7.4	8.4	**7.6**		8.8	9.5	9.6	9.4	**9.3**		9.3	9.3
Indus. Production (1967 = 100)	153.0	146.3	**150.9**	**2.6**	141.8	139.3	139.6	140.4	**140.3**	**−7.0**	142.9	145.5
Housing Starts (000)	961.7	865.3	**1099.8**	**−15.3**	920.3	956.0	1056.7	1075.1	**1002.1**	**−8.9**	1170.6	1332.7
Domestic Auto Sales (000)	6933.3	5184.0	**6271.0**	**−4.9**	5966.7	5466.7	5811.1	5759.8	**5751.1**	**−8.3**	6485.9	6318.2
Corporate Pre-Tax Profits	233.3	216.5	**232.1**	**−4.3**	171.6	164.7	172.6	169.4	**169.6**	**−26.9**	171.6	182.2
−Taxes	82.4	71.6	**81.2**	**−4.1**	55.8	51.2	55.5	54.8	**54.3**	**−33.1**	58.7	62.7
Net Profits	150.8	144.9	**150.9**	**−4.4**	115.9	113.5	117.1	114.7	**115.3**	**−23.6**	112.9	119.5
−Dividend Payments	66.8	68.1	**65.1**	**12.1**	68.8	69.3	70.1	71.0	**69.8**	**7.2**	71.9	73.1
Undistributed Profits	84.0	76.9	**85.8**	**−14.0**	47.0	44.2	47.0	43.7	**45.5**	**−47.0**	40.9	46.5
+Depreciation	192.6	200.5	**189.3**	**15.9**	208.8	217.4	224.8	234.3	**221.3**	**16.9**	245.2	252.8
−Inventory Profits	23.0	17.1	**24.6**	**−42.8**	4.4	6.3	8.9	11.1	**7.7**	**−68.8**	11.9	13.1
Net Cash Flow	253.6	260.3	**250.6**	**13.8**	251.4	255.3	262.9	266.9	**259.1**	**3.4**	274.2	286.2

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

SEPTEMBER 1982

A Time for Reason

"The only thing we have to fear is fear itself."
—Franklin Delano Roosevelt (First Inaugural Address)

Throughout history there have been times when a unique conjunction of events has led to deep uneasiness and, on a number of occasions, to widespread proclamations of crisis. The past few months might give one the impression that we are passing through such a period. A few large banks incur quarterly losses and rumors circulate that a number of large banks are "in trouble." A few developing countries find that they must reschedule their debt and rumors circulate that the entire international financial structure is coming apart at the seams. Unemployment and business failures increase as economic growth is halted in the important developed countries because they are getting control over their domestic inflation and the financial press reports that the world is set on a course that will soon lead to world-wide depression.

In a setting where economic growth has been absent for a number of years and where governments appear to be pursuing policies that do not give encouragement as to its early revival, rumors dealing with the soundness of the international financial structure in general and the banks in particular can easily get started. Traders of funds and securities are in touch with each other constantly and must react instantly to every news item—whatever its ultimate veracity. The financial press, ever-hungry for new developments to report, many times tends to elevate rumors to the point where they are accepted as the gospel, in effect turning hearsay into self-fulfilling prophecy. How valid are these rumors and fears?

Even a Candide could not blind himself to the existence of some economic and financial problems in the U.S. and elsewhere. Nearly four years of essentially no economic growth have produced jobless rates here not seen in over forty years and rates of business failures not seen since the early 1930s. Entire regions and whole industries are experiencing depression-like conditions. Since the U.S. bulks so large in world markets, our stagnant economy has affected many others. To prevent an even deeper plunge in the value of their currencies against the U.S. dollar than that which has already occurred, many countries have been forced to maintain high interest rates, which, in turn, has squeezed down their economies. Another depressant is the lower level of exports to the U.S. from developed as well as less developed countries because of our reduced demand. Finally, the much slower pace of inflation has cut into the ability of many countries—particularly the developing countries which tend to be commodity exporters—to generate enough foreign exchange to cover their imports and pay their bills.

The Roots Of The Problem

Like so many "crises," the current situation did not appear overnight. Rather, it is the culmination of a series of developments stretching back nearly ten years. At that time, most of the world's currencies were set free from their moorings to float against one another. During the first two years of generalized floating, 1973 and 1974, day-to-day changes in the relationship of currency values to one another were unusually large—sometimes as much as two per cent in a single day. While several financial institutions incurred losses in their foreign exchange trading as a result of not being able to cope correctly with this new environment, it should be noted that world trade did not collapse with the fall of Bretton Woods. Quite the contrary, despite the advent of floating exchange rates—which some feared would lead to a contraction of world trade—multilateral commerce expanded. In 1970, before currencies were free to float, only one-eighth of total world output was traded internationally. Ten years later, that share had increased to nearly one-quarter.

The arrival of the floating exchange rate "system" came none too soon. For beginning in late 1973, international oil prices took a quantum leap upward, causing the oil exporting countries to develop massive foreign exchange surpluses and the oil importing countries to incur large deficits. The word "recycling"

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came into general use as shorthand for nothing less than the greatest transfer of wealth in the history of mankind — that is, channeling the surpluses of the oil-exporting countries into those importing countries with the greatest need. As you will recall, there were many at the time who said it simply could not work. The prophets of doom had a field day — and not without good reason, since there were two stumbling blocks in the way of a smooth accommodation to the circumstances. For one thing, the oil-exporting countries were initially inclined to invest the biggest portion of their revenues in assets of very short maturities. For another, the oil exporters directed their investments into those countries and currencies that promised the greatest safety for principal. Thus, large amounts flowed into the United States directly, landing mainly in Treasury bills and in the major U.S. banks.

Meanwhile, those countries that were importers of oil soon developed very large deficits. At the time, both developed and developing countries were in this position. They needed the oil money in amounts that would cover their trade deficits, and the process of obtaining these funds was handled efficiently by the private banking system. Some countries used these funds to invest in infrastructure which ultimately reduced their dependence on oil and/or generated an income stream sufficient to help pay their debts. Others, because of their less developed nature, were unable to do this and found themselves getting deeper and deeper in debt. Risk exposure began to rise in the mid-1970s leading to a greater reliance on direct government-to-government lending and recourse to such international agencies as the World Bank.

There were other by-products of this quantum leap in oil prices. For one thing, it set off a round of double-digit inflation in many countries because of the ubiquitous nature of the product. However, the unwillingness of the Federal Reserve to fully monetize the greater dollar needs associated with rising petroleum prices caused the U.S. to experience what until that time was its deepest recession in the postwar era. The much higher price of oil also had its effect on a number of key industries in the U.S. — not the least of which were automobiles and housing, two industries that had grown and prospered in an era of cheap, readily-available energy.

The 1973–75 recession took some of the steam out of the inflation that was generated by higher oil prices, but toward the end of the decade inflation began to flare up once again. In response, the Federal Reserve stopped focusing on trying to manage interest rates and began focusing on trying to manage the money supply — a policy known as monetarism. This produced a whole new set of circumstances for the banks in particular and the international financial system in general to cope with — such as domestic interest rates joining foreign exchange rates in being extremely volatile.

Monetarism soon accomplished its main objective — the slowing of inflation. From 13 per cent in 1979 (and an annual rate of nearly 20 per cent in first-quarter 1980), the rate of inflation in the U.S. slowed dramatically. By the summer of 1982, consumer prices in the U.S. were barely six percent higher than their year-ago levels — while wholesale prices were up only four per cent. Not surprisingly, this meant that prices of many items had actually fallen. Besides the widely-publicized price reductions in a number of big-ticket consumer durable goods, prices of basic commodities dropped significantly. Industrial commodities prices are now off about 25 per cent from their peaks reached 2½ years ago, while food commodities are down some 20 per cent. Many individual commodities are no higher today than levels first reached in the mid-1970s — while some are significantly below even that. This means, of course, that the income of many developing nations, which depend on exports of these commodities for their livelihoods, plunged sharply. At the same time, rapidly rising interest rates, a byproduct of earlier inflation and now the volatility of interest rates, themselves, added to these countries' debt burdens as well.

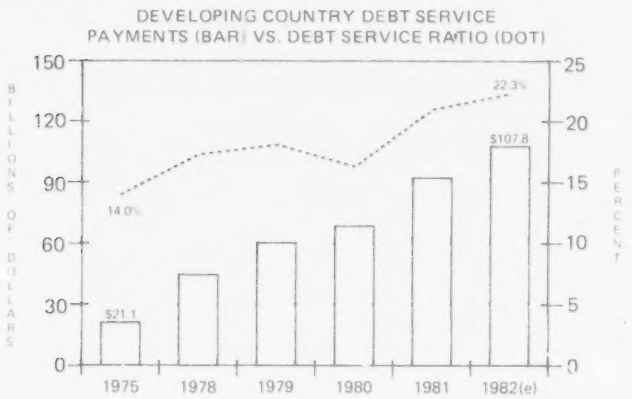
Another development germane to the current situation occurred early in 1981. Shortly after assuming office, President Reagan removed controls on crude oil prices. Soon after, world oil prices peaked and have been edging downward ever since. From a high of nearly $36 per barrel, the average price of crude oil in spot markets has since fallen below $32. At one point last spring, spot prices fell below $28 a barrel, causing a marked softening in what had been a booming industry: the search for, production, and distribution of oil. Those companies here and abroad engaged in this industry as well as those institutions which lent or invested money found themselves facing a new, undoubtedly surprising set of circumstances — as have countries of heretofore unquestioned credit rankings because of oil.

Through it all, a number of governments attempted to cope by a return to economic nationalism. Protectionism emerged under new guises; predatory financing and non-tariff barriers became the order of the day. There has been a decline in economic and monetary cooperation among the major nations of the world, in sharp contrast to the spirit of partnership that was the centerpiece of policy in much of the postwar period. But while governments increasingly have gone their own way, the world of international finance has become even more functionally integrated with the result that there is a growing disparity between how the world works and how governments govern. Some of the so-called "problem loans" confronting major

banks today are the result of initiatives taken in Washington and elsewhere that in effect have made private banks and international markets the cutting edge of foreign policy.

Rescheduling Is Nothing New

The fact that there is a logical explanation for all of this in no way, of course, minimizes whatever problems exist today in the international financial system. So let me turn to the problems, themselves, to see if they are as bad as they appear. Take rescheduling, for example. To read the plethora of articles in the financial press, one would think that rescheduling of previously incurred debt either by companies or



sovereign governments is something new. It is not. Bankers for centuries have worked with their customers — large and small — whenever it was apparent that the repayment of debt was becoming a problem. Internationally, rescheduling has been a fact of worldwide banking to sovereign governments — especially during the past quarter of a century. In fact, there have been 53 sovereign debt reschedulings since 1956 — proof that rescheduling can work! In the U.S., Washington "reschedules" its debt all the time — only here it is called "rolling over." According to the Treasury, the U.S. rolls over about $11 billion of debt in its weekly Treasury bill auctions. The U.S. government has not paid *down* — much less paid *off* — its debt on an annual basis since 1969, the last time it ran a surplus in its budget.

Having said this, I must admit that a number of differences exist today compared with the past. For one thing, the process of financing oil-bloated payments deficits has stretched the capacity of many sovereign borrowers to service it. Although the chart shows an aggregate debt service ratio for the non-oil developing countries at a relatively comfortable point, some countries undoubtedly are at levels where it is becoming difficult to take care of their domestic needs while servicing their external debts. Here at home, the 50-year high level of business bankruptcies has taken its toll among companies large enough to have made the headlines with the debts they owe their bankers. In some cases the debts were rescheduled and the company involved returned to a viable state of health. In other cases the banks had to take a charge against earnings. The point is — bankers reschedule only when they believe that the problem can be resolved.

Let us look at the ability of the banks to withstand such chargeoffs domestically as well as what the implications of reschedulings to sovereign governments might mean. Because loan chargeoffs are up, banks have increased their provisions for possible future loan losses in order that total loan loss reserves be maintained at an adequate level. But in spite of this bank earnings are still healthy. Thus even if there is a need to charge off additional loans made to private corporations, the banks are well able to withstand this. As for loans to nations, with the exception of Cuba, no American bank in the postwar era has lost a penny on loans to sovereign governments. For whenever a sovereign government attempted to repudiate its international debt, it was faced with having to do without the system within which it had operated.

Needless to say, the current situation is not one that we can be unconcerned about. Rather, it should — and can — be ameliorated. We may never eliminate the need for normal reschedulings because the need to adjust banking arrangements to meet the changing circumstances of borrowers is something that has always been with us, whatever name we give it. And, it should be remembered that the banks do provide the mechanism for accommodating economic imbalances in an uneven world — imbalances which, at times, may temporarily strain this mechanism, but not break it. That is, after all, the role of banks in economic systems. Nevertheless, today's high rates of joblessness and business failures demand that anything that can be done to moderate these circumstances should be.

Some Possible Solutions

I have several suggestions. For one thing, an America back on course will have many salutory effects on the rest of the world. If we could begin growing again, our domestic corporations would generate the cash flow necessary to help pay their debts, while our trading partners would find markets more receptive to their goods — especially those raw materials now languishing for lack of demand. Lower interest rates would help both private corporations and sovereign governments bear the burden of debt. All of this can come about if Washington does some restructuring of its own — its economic policy. I speak of a more restrictive fiscal policy linked with a more accommodative monetary policy.

Inflation may not have been wiped out, but with some 30 per cent of our industrial capacity lying idle, nearly

11 million people out of work, and commodities prices well below their recent peaks, inflation does not seem likely to revive quickly if the monetary authorities were to be a little more generous in providing money to the system. On the fiscal side, the government must turn away from benign neglect of deficits and realize that they *do* matter. The true burden of government is reduced, not just by cutting taxes, but by lowering spending as well. If taxes are reduced and spending is not, the burden is just as onerous as it was before, if not more so.

A worldwide recovery will help firm up most commodities prices — especially relative to oil prices. This must happen, if the non-oil developing countries are to once again pay their own way in world trading markets. You cannot lift such an important commodity as oil out of the giant matrix of commodities worldwide, increase its price manyfold in a short period of time, and not expect to see adverse effects in a variety of areas.

Finally, it must be recognized that the banks always have and always will help those customers of theirs — be they individuals, private corporations or sovereign governments — who find themselves temporarily illiquid, but not insolvent. In particular, the process of rescheduling sovereign debt will be aided by a recognition that governments have a larger role to play in development finance. This Bank has already endorsed the Administration's call for a greater amount of co-financings between the World Bank and private lenders. Foreign aid may be out of fashion these days, along with stepped-up funding for the IMF, the World Bank, and its affiliate, the IDA. But all are essential in addressing the urgency and magnitude of development financing requirements. Along with these official sources, of course, there is a role for private institutions, sometimes acting alone and sometimes in concert with official agencies. But this is no time to be diminishing the resources of official agencies in the expectation that private sources can fill the gap. Governments of developing countries will need a level of help that goes beyond the capacity of private sources.

Nevertheless, the growth and size of developing country debt should not be exaggerated. As the chart on page three also shows, a five-fold increase in developing country debt service payments between 1975 and 1982 led to only an 8.3 percentage point rise in their aggregate debt service ratio. This means that their gross national products as well as their exports of goods and services rose, too — although obviously not as rapidly. Debt service was also bloated by its concentration in short maturities, whose interest rates rose with the general rate structure.

The underlying economic and financial circumstances today do not justify the atmosphere of alarm that the media appear to be generating. Past economic crises, including the Great Depression, would not have happened based on economic circumstances alone. They were created by waves of fears and rumors that helped bring about the feared results. Responsible policies by governments, industrial concerns, financial institutions—and the media—can and will avoid the extreme dangers that are now so much on everyone's mind.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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and Economist

OCTOBER 1982

Business Conditions Update

The surge in stock prices since late August has given rise to hopes that the U.S. economy may at last be on the verge of breaking out of its protracted slump. Although its record as a forecaster of downturns is checkered, the stock market has not failed to anticipate a business recovery during the postwar era. In my opinion, a good case can be made that this time will be no exception. However, I would question the strength and duration of the business upturn, when it develops. For while the conditions that produced what may well turn out to be the worst recession since the 1930s may have been alleviated somewhat, they have not been eradicated altogether. What is more, they could worsen well before the end of next year, suggesting the possibility of renewed recession, inflation—or both.

Few Signs of Recovery ...

The rally on Wall Street has been greeted with more than the usual degree of skepticism. To the uninitiated, the stock market seems to be marching to the beat of a different drummer than the real economy. While the popular market averages have climbed by about a third since late August, there are few, if any signs that the real economy has stopped weakening—much less begun to strengthen. Businesses continue to fold up at rates not seen since the 1930s, producing the highest level and rate of unemployment since just before World War II. Compared with an average decline of 10.3 percent in each of the seven postwar recessions, industrial production is off 11 percent so far with every category down except defense. Capacity utilization at the end of the third quarter dropped to 69.1 percent—about equal to the postwar low of 69 percent reached in the depths of the 1973-75 recession.

Looking at the broader-based gross national product figures produces just as bleak a picture. While the real GNP rose by 0.8 percent in the third quarter of 1982 after increasing 2.1 percent in the second, real sales to final consumers decreased 0.6 percent in the third quarter after a decline of 0.9 percent in the second quarter. In other words—with the exception of an $800 million rise in the first quarter this year, sales to final consumers adjusted for inflation have been falling since summer 1981.

There were declines in at least part of each major gross national product category. While consumer spending rose $3.4 billion in the third quarter, after factoring out inflation, purchases of durable goods decreased by $1.5 billion. Business spending fell on all fronts. Real nonresidential fixed investment decreased $5.7 billion in the third quarter after falling $5.3 billion in the second. Nonresidential construction outlays decreased by $1.2 billion after virtually stabilizing in the second quarter and there was a hefty decline of $4.5 billion in producers durable equipment purchases in the third quarter following an even bigger decrease of $5.5 billion in the second quarter. Reflecting the combination of an overvalued dollar and recessions abroad, exports decreased by $4.2 billion in real terms while imports rose by almost $1 billion.

In one category of business spending there was a rise—but this is not good news. Inventories increased by $700 million in the third quarter, following decreases of $4.4 billion in the second and $15.4 billion in the first. Because of the way the National Accounts are put together, a change from inventory liquidation to inventory accumulation adds to the GNP (in this case, $5.1 billion) but this can hardly be considered a sign of strength, in view of the protracted decline in final sales.

Apparently the largest accumulation of inventories occurred at the wholesale and retail levels. Earlier in the quarter, merchants were preparing for an upturn in sales. They usually pick up toward the end of the summer—and this time hopes were bolstered by the July 1 tax cut and increase in Social Security benefits. But as demand fell below expectations, inventories soared. If sales continue weak in the current quarter, wholesalers and retailers will slice orders—instead of increasing them, as they usually do this time of year—and this will mean further cutbacks in production and increases in layoffs.

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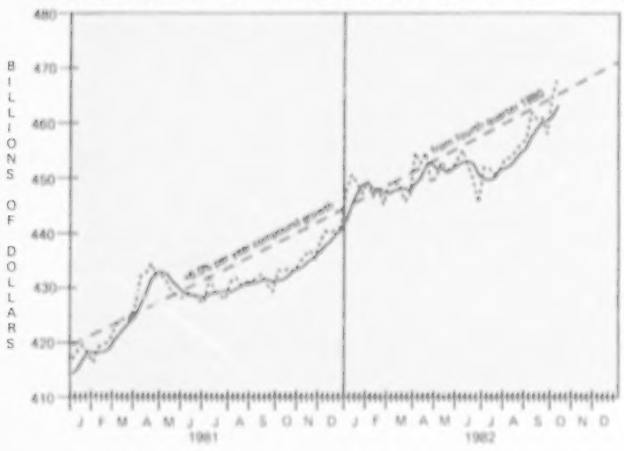
But the rise in the stock market offers some hope that the coming holiday buying season may mark the beginning of a pickup in consumer spending. The recent rally caused the value of stocks in the hands of the nation's 32 million individual stockholders to jump by close to $200 billion. Add to this another $50 billion increase in the value of Treasury securities held by the public and you have an increase in consumer wealth of at least $250 billion in barely two months' time. That is equal to the rise in total personal incomes that took place in the entire year 1981! Plainly, this much of an increase this soon is bound to lead to some increase in consumer spending. The literature suggests that when consumers believe they are wealthier, they will spend more. How much will depend on a variety of factors not the least of which is confidence.

CHART I
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE) VS. WEEKLY FIGURES (DOT)



A rise in the stock market such as was experienced over the past couple of months is enough to make some people at least a little bit more optimistic. But this will not translate into greater rates of spending for the non-shareholders until their own personal experience confirms it. And an even longer period of time will be necessary before higher stock prices translate into increased business spending—notwithstanding the decline in the cost of obtaining funds that a rising stock market brings. Executives will need a greater inflow of orders and a much higher rate of capacity utilization before they begin to think about increasing spending for new factories, office buildings, machinery and equipment.

Another reason why the stock market rally has been denigrated is that it seems to have occurred largely because of what the markets believe to be a change in Federal Reserve monetary policy—not because of any fundamental change in business conditions. There is a widespread belief on Wall Street that the Federal Reserve has eased monetary policy, whether you look at it from the point of view of the monetarists or the Keynesians. Monetarists look at the growth of money and credit and since midyear the money supply M1 has shot up at about a 14 percent annual rate compared with virtually no growth at all during the previous six months. Keynesians look at interest rates, and since midyear short-term interest rates have dropped by as much as seven percentage points, while long-term rates have fallen by about 4½ points.

Of course, both money supply growth rates and interest rates have gyrated significantly since October 6, 1979, when the Federal Reserve switched to a monetarist-oriented monetary policy. So for the stock market to have rallied the way it did, it had to be convinced that this was more than just simply another zigzag. Investors apparently concluded that the combination of a much-reduced rate of inflation, growing strains in the financial system, and the protracted weakness in economic activity finally persuaded the central bank to change the focus of its monetary policy from fighting inflation to fighting recession.

Notwithstanding the rise in the stock market, there remains a considerable difference of opinion over whether the Federal Reserve has really changed its policy. To be sure, the public statements of various Federal Reserve officials have sought to minimize the significance of any policy change, calling it "technical in nature with zero policy significance." This is no doubt designed to assuage the fears of those who believe that, left unchecked, current rates of money growth could dissolve into a new round of inflation psychology and ultimately sharply rising prices. Yet the facts are that there has been a considerable degree of expansion in money and credit since midyear and a sizable drop in interest rates, so those who believe that the Fed has executed a policy shift may not be entirely wrong.

Whether the Fed has changed policy or not, investors in equities believe it did and that's why they jumped into the stock market. Such a development is not unusual at this point in the business cycle. Studies show that changes in the direction of interest rates do have a significant bearing on stock prices. As interest rates fall, stocks become more attractive—especially to institutional investors who have sizable amounts of money coming in constantly that must be invested prudently, in relatively liquid instruments, and in markets that they will not overwhelm by sheer size. Conversely, when interest rates rise, these funds are pulled out of equities because fixed-income securities offer more competitive rates of return.

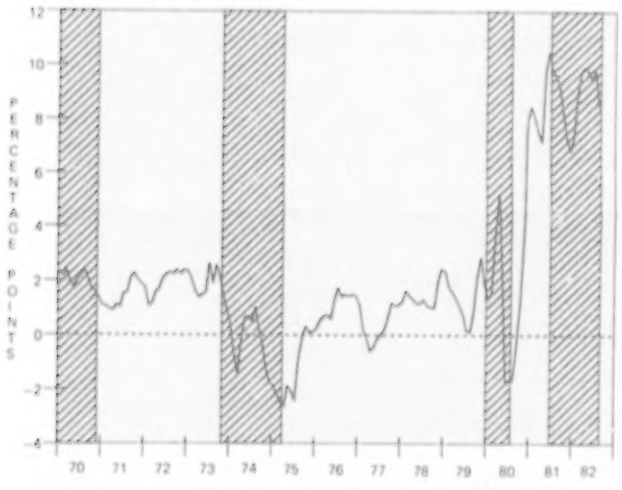
... But A Modest Upswing ...

Whether stocks hold all of their gains or not, I would think that the economy will strengthen a bit in the near future—if it has not already done so. This is because interest rates charged on a variety of loans to consumers have joined those that business pays in declining. While lower interest rates will not reduce the

monthly payment on automobiles by very much, they might have a psychological effect, spurring sales of new cars. The same might be said for other types of consumer loans. The impact of swings in interest rates is greatest when it comes to homebuying, and here, the decline in mortgage interest rates that has already taken place has increased the percentage of households that can theoretically afford to buy a house from its low of 15 percent in March to nearly 20 percent today.

Another factor that will help the recovery is the much slower rate of inflation. Buying power (after-tax income adjusted for inflation) is rising on an annual basis—as has been the case since the middle of 1980. It is growing faster than rates that prevailed at the conclusion of the 1980 recession as well as the end of the 73-75 recession. Inflation is likely to remain at or below the five to six percent zone for the next year or so for a variety of reasons. Commodities prices are off some 20 to 30 percent from their recent peaks, one-third of American capacity is lying idle, the unemployment rate, of course, is at a postwar high—and, notwithstanding the recent surge in money growth, over a two-year period the money supply has not expanded all that rapidly (Chart I). As consumers see that they can afford to spend and/or borrow to buy goods, their pent up demands for such items as cars and houses will take over and produce improved sales in these two important categories. Meanwhile, spending on services, small ticket hardgoods and softgoods is likely to remain firm.

CHART II
SPREAD BETWEEN PRIME RATE AND INFLATION RATE



However, none of this really adds up to a typical business cycle recovery, where the real gross national product in the first year of the upswing would grow by rates of six percent or more. The way I see it, it boils down to one reason: Interest rates are still historically high when compared with inflation. As you can see from the next two charts (Charts II and III), interest rates on short-term business loans as well as those in the bond markets may have fallen considerably from their peaks of 1981-1982, but when compared with inflation, they still remain historically high. Indeed, before they fell, real interest rates were at their highest levels since the early 1930s. You will notice that in the 1973-73 recession, and again toward the end of the 1980 recession, real long- and short-term interest rates turned negative—that is, they were below the 12 month rate of inflation at that time. Those levels of interest rates provided great incentive for people to borrow to buy new cars, houses and other major items. It was also an incentive for business to borrow in order to expand its pace of operations and its ability to produce.

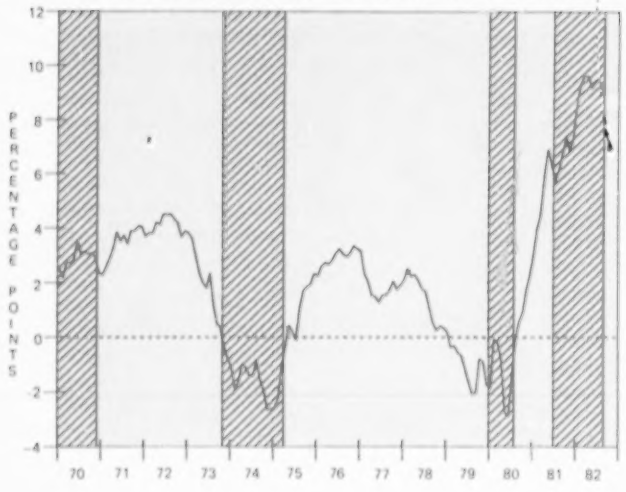
. . . Seems Likely To Occur

Today's comparatively high real rates of interest will serve to retard the economic recovery. High real interest rates are a deterrent to borrowing and an incentive for saving. High real interest rates will keep the dollar in its overvalued position by discouraging exports and promoting imports. Unless and until real interest rates descend to more "normal" levels, they will act as a brake on the economic recovery.

The question might occur why did interest rates break their historic relation with inflation in the first place. No one knows with any certainty, but it seems to me to trace to several recent developments. The greater volatility of both interest rates and the money supply following the Federal Reserve's shift to monetarism three years ago seems to have added a "volatility premium" to the level of interest rates besides the inflation premium and the "rent" premium, both of which had been embodied in interest rates for many years. In summer of 1981, another premium might have been added, one that, for lack of a better term, could be called a "fear" premium. The markets got scared in summer of 1981, when Washington revealed that the government's budget deficits were not going to get smaller and eventually disappear by mid-decade, but rather, were going to get bigger and expand into the 12-digit territory. The fear was that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving interest rates up in the process—or that they wouldn't; that the Federal Reserve would monetarize these deficits, but in the process, set the stage for a new round of inflation.

These last two premiums are still embodied in interest rates today—although they appear to be temporarily suppressed. Plainly, both the money supply and interest rates remain volatile, although not as much as in the period immediately following the Fed's October 6, 1979 policy switch. As for the fear premium, it is apparent that the markets fear recession, high unemployment, business failures, etc., more at the moment than they do inflation. However, this should not last too long, since, as I have pointed out above, a recovery seems to be

CHART III
SPREAD BETWEEN AA UTILITY RATE AND INFLATION RATE



getting underway. The question then becomes when will the markets change their focus from recession to inflation once again. The answer to this will determine how much longer the Fed will be able to concentrate on interest rates and money market conditions before it is forced to go back to the automatic pilot of trying to control money supply growth.

At the risk of being repetitive, I would like to point out that the Fed's ability to manage the money supply and keep interest rates down would be significantly enhanced were fiscal policy to work in tandem. Right now, as you know, there is no synchronization of fiscal and monetary policies. Monetary policy has been comparatively tight, while fiscal policy has been extremely easy and seems likely to impart even more stimulus over the near term. This Report warned two years ago (November 1980) of the consequences of cutting taxes before putting into effect offsetting reductions in outlays: "This simply will not work. Its near-term impact on the Federal government's financing needs will be devastating, since any policy that calls for more spending and less taxes—regardless of what their classroom results might be—will in the real world widen an already swollen budget deficit." The Report went on to say that bigger deficits combined with tight money will produce higher interest rates and a weak economy.

This combination of policies has been modified only slightly in recent months. As I have already observed, the monetary authorities are undoubtedly more generous with money and credit today than during the first half of 1982. And fiscal policy has been tightened a notch by the passage of the tax bill that calls for "enhancing" Federal government revenues by $100 billion over a three-year period of time. But more needs to be done if we are to continue to enjoy low rates of inflation while at the same time strengthening the private economy. I would say that the Federal Reserve has done about as much as can be expected, given our recent experiences with rapid money growth and inflation. It seems to me that more must be done on the fiscal side.

Some people—both in and out of Washington—find it hard to understand why fiscal policy must be tightened in order to get us out of this recession, whereas the conventional prescription calls for a loosening of fiscal policy. I think I have already given you the answer: When the government loosened fiscal policy, the resulting deficits came as such a shock to the markets that they moved interest rates higher to protect themselves from the consequences of greater government borrowing with or without an easier Federal Reserve monetary policy. These higher interest rates added to government costs, of course. At the same time, by remaining way above historical levels relative to inflation, these high interest rates sent the economy down and many businesses with it. That cut into government revenues and further increased government spending on unemployment benefits, food stamps, etc.

Loosening fiscal policy even more is not going to solve anything, since it will increase the budget deficit, hence the government's borrowing requirements. To repeat what I said in November 1980: "If the Federal Reserve supplies the amount of money and credit necessary to meet Washington's increased financing requirements while accomodating everyone else, inflation will undoubtedly worsen. If the Fed reverts back to a tight money policy, inflation will stay down—but so will the real private economy."

As for how to reduce the budget deficit, let me suggest that politicians of all stripes have great difficulty appearing before their constituents asking for their vote while cutting spending on projects that benefit them. If spending cannot be reduced then taxes must be increased—and the ones I have in mind fall under the heading of the Economic Recovery Tax Act (ERTA) of 1981. Originally designed to be a revenue raiser, ERTA, by the Administration's own admission, has become a revenue loser.

We would all like the burden of government to be reduced, but as this Report said last month, "the true burden of government is reduced, not just by cutting taxes, but by lowering spending as well. If taxes are reduced and spending is not, the burden is just as onerous as it was before, if not more so." Washington gets money to spend in one of three ways: It borrows from the Federal Reserve, from the private sector, and it taxes. We have seen what happens when too much emphasis is placed on borrowing from the Fed: Inflation. In recent months, Washington has borrowed mainly from the private sector: That has produced recession. Isn't it about time we tried the third route: Taxes? After all, we as individuals are ultimately constrained by our incomes; why should we expect any less of our government?

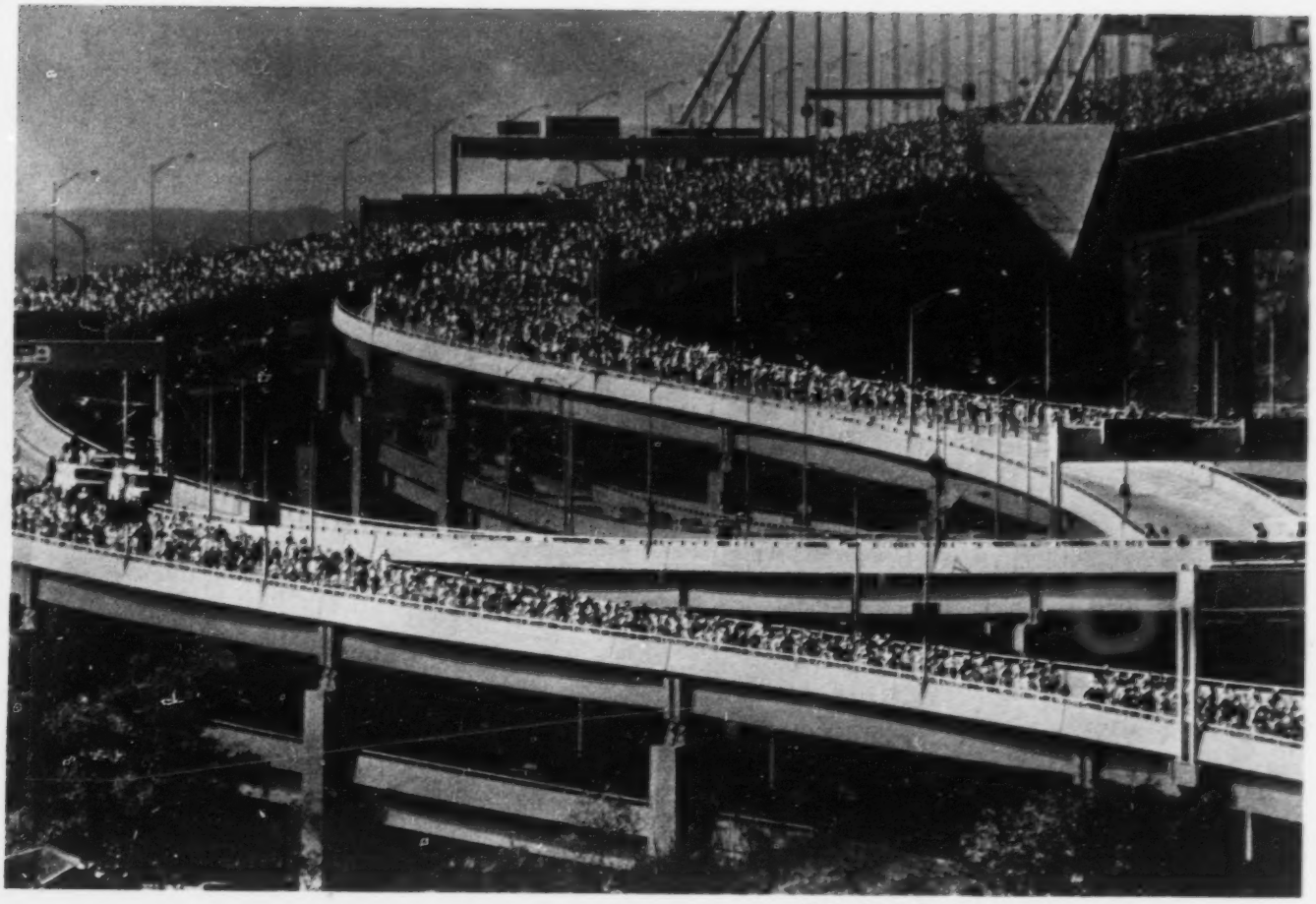
October, 1982

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

			< Actual			Projected >								
	YEAR 1981		1982				YEAR 1982		1983				YEAR 1983	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	**2937.7**	**11.6**	2995.5	3045.2	3091.4	3152.2	**3071.1**	**4.5**	3219.4	3285.9	3355.5	3437.0	**3324.5**	**8.3**
GNP: $72	**1502.6**	**1.9**	1470.7	1478.4	1481.2	1489.9	**1480.0**	**−1.5**	1499.8	1511.3	1522.6	1535.7	**1517.3**	**2.5**
% Change, Annual Rates	**1.9**		−5.1	2.1	0.8	2.4	**−1.5**		2.7	3.1	3.0	3.5	**2.5**	
Consumption	**1843.1**	**10.6**	1919.4	1947.8	1989.5	2026.5	**1970.8**	**6.9**	2067.0	2109.7	2155.0	2201.9	**2133.4**	**8.3**
Durables	**234.5**	**9.4**	237.9	240.7	240.6	249.6	**242.2**	**3.3**	254.9	263.8	272.8	282.3	**268.5**	**10.8**
Non-Durables	**734.5**	**9.6**	749.1	755.0	770.8	777.5	**763.1**	**3.9**	790.0	800.4	812.6	824.9	**807.0**	**5.7**
Services	**874.1**	**11.7**	932.4	952.1	978.1	999.4	**965.5**	**10.5**	1022.1	1045.4	1069.6	1094.6	**1058.0**	**9.6**
Investment	**471.5**	**17.2**	414.8	431.5	438.5	438.0	**430.7**	**−8.7**	456.7	472.1	489.9	509.1	**482.0**	**11.9**
Non-Residential	**346.1**	**12.0**	357.0	352.2	341.6	334.6	**346.4**	**0.1**	336.5	340.8	349.5	360.0	**346.7**	**0.1**
Producers Durable Equipment	**216.4**	**8.9**	215.6	208.6	201.0	198.3	**205.9**	**−4.9**	201.4	206.3	212.9	220.3	**210.2**	**2.1**
Structures	**129.7**	**17.4**	141.4	143.6	140.5	136.4	**140.5**	**8.3**	135.0	134.5	136.6	139.6	**136.5**	**−2.9**
Residential	**105.0**	**1.7**	93.4	95.5	97.4	107.3	**98.4**	**−6.2**	116.8	124.1	130.3	136.3	**126.9**	**29.0**
Inventory Changes	**20.4**		−35.6	−16.2	−0.5	−3.9	**−14.1**		3.4	7.2	10.2	12.8	**8.4**	
Net Exports	**26.1**		31.3	34.9	13.2	18.6	**24.5**		22.0	19.1	16.8	19.6	**19.4**	
Government Purchases	**597.0**	**10.9**	630.1	630.9	650.2	669.1	**645.1**	**8.1**	673.7	685.0	693.8	706.3	**689.7**	**6.9**
Federal Defense	**153.7**	**17.0**	166.2	176.2	183.7	191.7	**179.5**	**16.7**	195.6	199.9	202.1	210.9	**202.1**	**12.6**
Federal Civilian	**75.2**	**14.3**	83.5	68.2	73.9	78.4	**76.0**	**1.0**	76.9	76.3	77.4	77.1	**76.9**	**1.2**
State & Local	**368.0**	**7.8**	380.4	386.6	392.6	399.1	**389.7**	**5.9**	401.2	408.9	414.3	418.4	**410.7**	**5.4**
Final Sales: $72	**1493.7**	**1.0**	1486.1	1482.7	1480.6	1491.4	**1485.2**	**−0.6**	1498.3	1508.2	1518.5	1530.7	**1513.9**	**1.9**
% Change, Annual Rates	**1.0**		0.2	−0.9	−0.6	3.0	**−0.6**		1.8	2.7	2.8	3.2	**1.9**	
GNP Price Index (1972 = 100)	**195.5**	**9.4**	203.7	206.0	208.7	211.6	**207.5**	**6.1**	214.7	217.4	220.4	223.8	**219.1**	**5.6**
% Change, Annual Rates	**9.4**		4.3	4.6	5.4	5.6	**6.1**		5.9	5.3	5.5	6.4	**5.6**	
PCE Deflator (1972 = 100)	**194.5**	**8.6**	202.2	204.0	207.6	209.8	**205.9**	**5.9**	212.8	215.6	218.5	221.5	**217.1**	**5.4**
% Change, Annual Rates	**8.6**		4.9	3.6	7.2	4.4	**5.9**		5.8	5.3	5.5	5.5	**5.4**	
Consumer Price Index (1967 = 100)	**272.4**	**10.3**	283.6	286.8	292.1	294.1	**289.1**	**6.1**	298.1	302.2	306.4	310.7	**304.4**	**5.3**
% Change, Annual Rates	**10.3**		3.2	4.6	7.6	2.7	**6.1**		5.6	5.6	5.7	5.7	**5.3**	
Total Personal Income	**2415.8**	**11.8**	2510.4	2552.5	2597.9	2638.3	**2574.8**	**6.6**	2688.1	2742.9	2806.7	2873.5	**2777.8**	**7.9**
Disposable Personal Income	**2029.1**	**11.2**	2117.1	2151.5	2202.3	2236.5	**2176.8**	**7.3**	2274.6	2320.4	2393.8	2447.4	**2359.0**	**8.4**
Savings Rate	**6.4**		6.6	6.7	6.9	6.6	**6.7**		6.4	6.3	7.2	7.3	**6.8**	
Employment Rate	**58.8**		57.9	57.8	57.7	57.5	**57.7**		57.6	57.9	58.1	58.4	**58.0**	
Unemployment Rate	**7.6**		8.8	9.5	9.9	10.3	**9.6**		10.2	9.9	9.8	9.6	**9.9**	
Indus. Production (1967 = 100)	**150.9**	**2.6**	141.8	139.4	138.1	137.5	**139.2**	**−7.8**	139.9	142.2	144.5	147.6	**143.5**	**3.1**
Housing Starts (000)	**1099.8**	**−15.3**	920.3	952.0	1113.7	1149.3	**1033.8**	**−6.0**	1227.4	1340.3	1331.0	1462.9	**1340.4**	**29.7**
Domestic Auto Sales (000)	**6216.7**	**−5.4**	5733.3	5466.7	5504.3	5736.9	**5610.3**	**−9.8**	6048.5	6165.0	6412.6	6739.7	**6341.4**	**13.0**
Corporate Pre-Tax Profits	**232.1**	**−8.3**	171.6	171.7	174.9	178.7	**174.2**	**−24.9**	184.0	192.2	198.5	208.5	**195.8**	**12.4**
− Taxes	**81.2**	**−4.1**	56.7	55.3	56.4	58.4	**56.7**	**−30.1**	64.5	67.7	69.9	73.7	**68.9**	**21.6**
Net Profits	**150.9**	**−4.4**	115.0	116.3	118.5	120.3	**117.5**	**−22.1**	119.6	124.5	128.6	134.8	**126.9**	**8.0**
− Dividend Payments	**65.1**	**12.1**	68.8	69.3	70.5	72.0	**70.2**	**7.8**	73.5	74.8	76.2	77.6	**75.5**	**7.6**
Undistributed Profits	**85.8**	**−14.0**	46.1	47.0	48.0	48.2	**47.3**	**−44.8**	46.1	49.7	52.5	57.3	**51.4**	**8.6**
+ Depreciation	**189.3**	**15.9**	208.8	216.5	223.8	234.3	**220.8**	**16.6**	246.1	253.6	261.4	268.8	**257.5**	**16.6**
− Inventory Profits	**24.6**	**−42.8**	4.4	9.4	11.4	3.3	**7.1**	**−71.0**	8.2	13.1	14.3	16.5	**13.0**	**82.5**
Net Cash Flow	**250.6**	**13.8**	250.5	254.1	260.4	279.2	**261.0**	**4.2**	284.0	290.3	299.6	309.6	**295.9**	**13.3**



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